What You Need to Know About Today's

Credit Union

For Employees, Volunteers and Members

by

Paul Thompson, CUDE

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Author of

Development of the Modern U.S. Credit Union Movement 1970-2010
Available from lulu.com

Dedicated to
my wife Evelyn
and our daughters,
Elizabeth and Gwendolyn

With thanks to the credit unionists
who contributed suggestions
and input to this project

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Contents

"Credit unions exist for members.

"We should never let this slip from our minds. It is worthy of placing on a banner to drape in every branch's lobby: Credit unions are for members."

— Ed Callahan, *A Coach's Playbook for Credit Unions*

Chapter One

What Makes a Credit Union a Credit Union?

Author's Note: I have been a credit union member since my cub reporting days long ago. But when I joined the Credit Union National Association as speechwriter for the leadership in 1986, I found I had much to learn about credit unions and their operations. I wish I'd had a book like this to guide me.

This book is a short and easy-reading introduction to the fundamentals of the credit union. It will be especially useful for credit union trainers, new employees, new volunteers, and interested credit union members. As a survey of the current movement, I believe it will also be of value to experienced credit unionists.

Let's begin with a story that's fictional but conveys the nature of the credit union. (Readers who are already familiar with credit union work may choose to skip to the next section.)

Jorge and Mary's Story

On a sunny but wintry Saturday, Jorge and Mary Rodriguez parked at a branch of Happy Hills Federal Credit Union and ventured inside. Mary took off her scarf and the baby's hat and tucked them in her jacket pocket. Her infant grinned up at her.

The interior looked warm and friendly but bank-like, with teller windows, side offices, and counters where you could stand to fill out deposit slips. There was a counter

with a coffee and hot chocolate dispenser and cookies on a plate.

They approached a middle-aged woman seated at a desk. Her brown hair was streaked with gray. Her name tag identified her as Eleanor. "Hi!" she said with a smile. "How can I help you?"

"Who do we see to open an account?" Mary asked.

"I can do that." She rose and they shook hands. "Please have a seat."

Eleanor Hoffman saw a young couple in dark winter clothing. The man was burly and had a mustache. He looked at his pretty wife and seemed to expect her to transact any business.

"Such an adorable baby," Eleanor said. "What is its name?"

"Christopher," Mary replied, glancing down with fondness at her infant. Her voice had the slightest trace of a Spanish accent. She looked up. "We have some questions."

"Sure. What do you want to know?"

"We're kind of unhappy with our bank. The service isn't that great, and they seem to look for excuses to add lots of fees. A friend recommended you. Can you tell me why you're better than our bank?"

Eleanor laughed. "Great question. Do you want the short answer or the long one?"

Mary smiled. "The short one, I guess."

"Well, we offer most of the same services as your bank probably does, but we're organized differently and we have a different mission."

"How do you mean?"

"Banks perform a lot of useful services. But a bank is owned by people who hold stock in the bank. The bank's main mission is to earn as much money for its stockholders as it can. That encourages the bank to charge as much as it can for its services. In addition, especially if it's a large bank, its most important customers are businesses. It isn't really interested in paying a lot of attention to little folks like you and me except as a source of revenue for its business loans."

"How is the credit union different?" Jorge asked. His voice was unexpectedly deep and melodious.

"First of all, Happy Hills is a cooperative. Are you familiar with cooperatives?"

"My father told me that back in Mexico, he helped run a farm cooperative," Jorge said.

"Then you probably know that a cooperative is owned by the people it serves. It's a business, and it needs to make a profit to stay in business, but its mission is to serve its owner members. Any profit left over after expenses are paid and money put aside for a rainy day goes back to the members in one way or another – such as improvements in services or better interest rates."

"So you don't try to make as much money as a bank does?" Mary asked.

Eleanor smiled. "I guess you could put it that way. Our members find they can often get a better deal at the credit union than at other financial institutions.

"We have something of a financial advantage because we don't have to pay dividends to private stockholders and we don't have the expense of paying our board of directors. And because our primary aim isn't profit but service, we're exempt from the corporate income tax, although we pay other taxes. But our main advantage is we're as friendly and helpful as possible. Our main focus

is serving people like you, not business. Though we do have some small business owners as members."

Mary nodded.

Eleanor continued. "You know, each year, the *American Banker* trade newspaper runs a survey of consumer satisfaction with various financial institutions. And every year since that survey began, credit unions have come out on top in consumer satisfaction. One more thing you should know. As owners of the credit union, our members elect our board. It's made up of seven unpaid volunteers from the membership. Their job is to see that Happy Hills sticks to its mission of serving members."

"That sounds nice," Mary said. "What do we do to become members?"

"I take it you live or work in Happy Hills."

Jorge nodded. "Jorge works," Mary said. "He's a cable television installer. I'm at home with Christopher."

"Well, you certainly are eligible to join the credit union."

Eleanor remembered that when she first came to the credit union it served a much narrower membership – local telephone workers. Then they had added a number of other employee groups ranging from workers at an automobile dealership to employees of a furniture factory. A few years ago, they had broadened their membership to include the whole community of Happy Hills.

In a way, she missed the old telephone credit union – it had been a more intimate group, and she had known many of the members by name. But now the credit union had an opportunity to serve many more people. like Jorge and Mary Rodriguez. They were the kind of young people just starting out who could benefit most from the credit union.

She handed them the short membership application. "It will take just a few minutes to fill out," she said. "You can take it home, if you like, and bring it back or mail it in. You can even fill it out online at our web site."

They chose to retire to one of the lobby counters to fill out the form with their basic information. Eleanor continued to reflect on changes in the credit union. She knew by sight and some by name members who were regular visitors to the branch. But increasingly, members – especially younger ones – were using the Internet and mobile devices to do their business. She regretted the loss of contact but realized today's marketplace centered around price, convenience, service, and trust.

When the young couple returned, she glanced at the form, asked for identification as required by law, and said: "Everything looks fine. Do I have your permission to run a quick credit check?" Mary glanced at Jorge and nodded. Eleanor tapped at her computer keyboard. If they had a poor credit rating, they would still be eligible for membership but would not be able to access some services until they used the credit union's "credit building" programs to improve their credit score.

"Okay, everything is in order. The only thing we need now is your ten dollar first deposit. Some credit unions require more, others less, but ten dollars is our requirement. That goes into a basic savings account. We call it a share account because it represents your share of ownership. We hold it for you and pay interest on it as long as you're members. We'll return it if you ever decide to leave the credit union."

"What about checking?" Mary asked.

"We can also open a checking account for you. We call it a share draft account, because again the money in the account represents your share in the credit union."

The couple opened a joint share draft account and deposited a check written on their bank. Eleanor provided them with a packet of temporary share drafts to use until they received their full order of personalized checks.

Eleanor watched them leave, feeling satisfaction at another membership. On the way out, Jorge snagged a cookie.

Credit Unions Meet Consumer Needs

Each day, similar scenes are enacted at thousands of U.S. credit unions – although not all provide cookies. As of 2014 the country's 6,700 credit unions counted some 100 million members. (There is some double counting in the membership figure, since some people belong to more than one credit union, but the figure is roughly accurate.)

Members seldom restrict their patronage to the credit union but use a variety of financial service providers. However, the credit union often plays a significant part in their lives.

As Eleanor Hoffman told Jorge and Mary, credit unions are financial service cooperatives operating not for profit but for service. They are something of an anomaly in our financial system.

The vast majority of banks, savings and loans, and other financial institutions, while providing vital services to the economy, are driven by the profit motive. Years ago, bank managers saw themselves as having responsibilities to three groups of people – stockholders, customers, and employees. Today, modern managerial theory emphasizes stockholder returns, and that is how managers are judged. This means bank executives must relentlessly seek higher profits to boost dividends and share price.

In recent decades, the larger banks have found ordinary banking activities not sufficient to obtain the kinds of profits – and multi-million-dollar managerial bonuses – they seek. As a result, they have moved further and further into all kinds of financial services and investments. This progress into less known and riskier waters was one factor that led to the banking crisis and "Great Recession" of 2007-2009.

Credit unions, prudently managed and focused on serving members, rode out the crisis in much better shape than the banks. Their failure rate was much lower, and, unlike many banks, they continued to make consumer and small business loans in the midst of recession.

The result of these trends and events has been a stream of bank customers moving into credit unions, accelerating their growth.

Chapter 2

The Cooperative Heritage

Credit unions are not the only cooperatives around. The United States has a strong cooperative sector. In 2014, some 29,000 cooperatives provided a wide variety of services to Americans, from natural food groceries to childcare to rural electric and telephone companies to farm purchasing and marketing coops. They employed some 2 million workers and held about $3 trillion in assets. Credit unions themselves are the single largest segment of the cooperative movement, holding some $1 trillion in assets.

The concept of cooperative action is certainly not new. As far back as history itself, people have joined forces to carry out jobs difficult for individuals to handle by themselves – whether raising a barn on the frontier, organizing a volunteer fire department, or joining together to create a cooperative store.

The cooperative movement in the United States dates back to colonial times, but received fresh stimulus from the periodic depressions and unbridled corporate capitalism of the later 1800s and early 1900s. While the "creative destruction" of capitalism led to many improvements in American life, from the automobile to the safety razor, it created vast wealth in the midst of much poverty.

Apologists for the corporate "robber barons" of the period seized upon the work of Charles Darwin and his idea of

the struggle for existence to justify the unfettered pursuit of profit. According to the social Darwinists, economic life was a struggle in which the fit survived and the weak went under. Attempts by reformers or government to regulate business or relieve the sufferings of the poor were simply interfering with the natural order of things.

The social Darwinists conveniently overlooked the fact that the big businesses of the era were rigging the game through bribery of legislators and government officials and collusion among themselves to eliminate competition and achieve monopolies. They also neglected Darwin's observation that cooperation as well as competition is an evolutionary force, a fact borne out by modern science. "(Cooperation) is in evidence at all levels throughout the natural world," note Oxford zoologists Stuart A. West, Claire El Mouden, and Andy Gardner.[1]

Idaho farm coop members examine new combine. 1930s. Library of Congress Photo.

Psychologist Michael Tomasello of MIT notes that this propensity is even more evident in humans and underlies our social institutions.[2] In short, even the most rapacious and selfish businessperson relies on cooperation with others to achieve his or her goals. The cooperative makes use of this instinct.

Some of the earliest American cooperatives were organized by farmers. They were used to working with each other to plant and harvest their crops.

1 *Sixteen common misconceptions about the evolution of cooperation in humans,* in the journal Evolution and Human Behavior, 32 (2011), 231-262.

In the later 1800s and the first half of the 20th century, faced with what they felt were unfair practices by grain elevator operators and other businesses serving their needs, they formed cooperatives to operate their own elevators, purchase supplies and groceries at a discount, supply electricity and telephone service, and market their produce. Today, such household names as Land O' Lakes (dairy), Sunkist (citrus), and Ocean Spray (cranberries and grapefruit) are among the better known agriculture marketing cooperatives.

The cooperative idea – people getting together to find a better deal – has caught on in many areas of activity. My wife and I, for instance, patronize several coop-type organizations: We are customers at a worker-owned grocery, members of an organic food coop, members of an agricultural cooperative that installed our furnace and central air conditioning, and members of a cooperative health maintenance organization (HMO). We shop at local independent hardware stores that belong to purchasing cooperatives that help them compete with the big boys. Our newspaper carries stories by the Associated Press, a cooperative news-gathering organization. And we belong to several credit unions.

Early Credit Unions

The first credit unions were formed in Europe in the 19th Century and then in Canada. Members contributed savings, which were used to make loans to members in need of credit at reasonable interest rates. The idea was brought to the United States in late 1908 with the establishment of St. Mary's Bank in Manchester, New Hampshire, to serve French immigrant textile workers and their families. (St. Mary's Bank is still in operation. The building where it first began now houses America's Credit Union Museum.)

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2 *Why We Cooperate* , MIT Press, 2009.

The "Little Man" symbolized the early U.S. credit union movement. CUNA Cartoon.

St. Mary's Bank and other early credit unions filled a pressing need. Commercial banks served mainly businesses and the wealthy. Loan sharks preyed on working people, charging exorbitant interest rates.

The credit union model spread, with the financial backing of Boston merchant, philanthropist, and civic reformer Edward A. Filene. Roy Bergengren, a Boston lawyer interested in alleviating poverty, became the active partner in this effort. He traveled far and wide promoting credit unions, with great success. As credit unions and merchants offering credit demonstrated that working people could be good risks for loans, banks began to get into the act, and today they see "retail banking" as a profit center. However, their interest in consumer and small business lending tends to wax and wane with the profitability of their other lines of business.

The early U.S. credit unions were largely run by unpaid volunteers with missionary zeal who were "rank financial amateurs" who "learned the hard way" how to operate a financial institution, according to Mark H. Dorfman.[3]

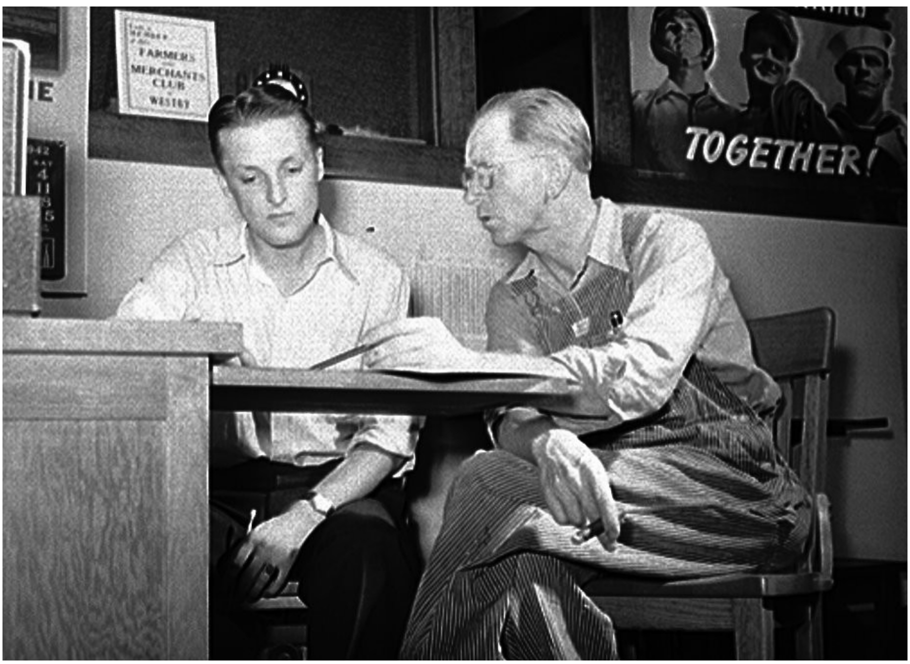
These financial cooperatives offered mainly savings accounts and small loans. The fact that records were

3 But for Service: A History of the Pennsylvania Credit Union League.

kept by hand meant that a credit union could serve only a few hundred or at most a few thousand people.

It was found that the most stable credit unions had members with a "common bond" like employment in a factory, belonging to a church congregation, or living in a neighborhood.

Employment was the most effective common bond, because members had a steady income and such a group was more tight-knit. The credit union's credit committee had a good chance to know borrowers personally and could judge if they could repay a loan. Peer pressure from workers whose savings were being loaned out and co-signing of loans also helped ensure repayment. As a



Before the 1970s, most credit unions were small and run by volunteers. They offered few services. Library of Congress Photo.

result, the great majority of credit unions came to be organized around the workplace.

Features like the common bond were enshrined in state and federal credit union laws, which were often drafted by Roy Bergengren himself.

Evolution of the Modern Credit Union Movement

By 1969, the U.S. credit union movement had grown to 23,866 credit unions with 21.6 million members and $15.9 billion in assets. The typical credit union was still relatively small and offered only "plain vanilla" savings accounts and small personal loans. The main difference between the early credit unions and those in the 1960s was that due to economic growth, many working class members had moved up from the economic margins – where a single event like illness could throw them into poverty – to the middle class. The U.S. movement at the end of the 1960s entered a period of rapid change. It began to consolidate, and many credit unions began to evolve into full service financial institutions. Factors behind this evolution included:

- **Passage of federal deposit insurance for credit union accounts in 1970.** This encouraged consumers to deposit more funds into credit unions. But insurance requirements forced the closure or merger of the weakest credit unions. Chartering requirements were raised so it was harder to form new credit unions.
- **Loosening of common bond requirements by regulators so credit unions could add groups to their base membership, as long as each group had its own common bond.** These groups came to be known as select employee groups (SEGs). This made it easier to grow the credit union and opened credit union services to

many groups too small to form their own credit union under the more stringent chartering requirements. It also made mergers easier between credit unions with different common bonds.

- **Computerization and electronic funds transfers that enabled credit unions to handle large numbers of members spread over a wide geographic area.** In addition, the rise of national credit bureaus made it easier to judge the creditworthiness of members without having to have personal acquaintance with them.
- **Removal of Depression-era legal restrictions that had assigned different niches to depository institutions, empowering credit unions to add products and services like checking and mortgages that had hitherto been the province of commercial banks and savings and loans.** This threw them into direct competition with their for-profit competitors.
- **Competitive pressures in the new financial marketplace and a growing regulatory burden.** Middle- and large-sized credit unions were often better able to compete effectively and hire the staff needed to comply with regulatory requirements. They could better afford automation and adding products and services, and also had lower costs per member. Their smaller counterparts struggled to keep up. This encouraged mergers above and beyond those imposed by insurance requirements.

Growth of a Credit Union

(Taken from the web page of Arsenal Credit Union, St. Louis, Missouri.)

We are a state-chartered, federally insured credit union that was organized in 1948.

Today, more than 23,000 people enjoy the benefits of credit union membership at Arsenal.

Our credit union originally formed to serve the employees of what is now the National Geospatial-Intelligence Agency (NGA). While we still have a restricted-access office on its base to serve these members, over the years we have added five other branch locations throughout the St. Louis metro area and expanded our field of membership to include other select employee groups and communities.

We primarily serve those who live or work in St. Louis County, the city of St. Louis, and Jefferson County. Our field of membership also includes eight ZIP codes in Franklin County, the entire counties of Madison, Monroe, Randolph and St. Clair in Illinois, 16 select employee groups and two trade unions.

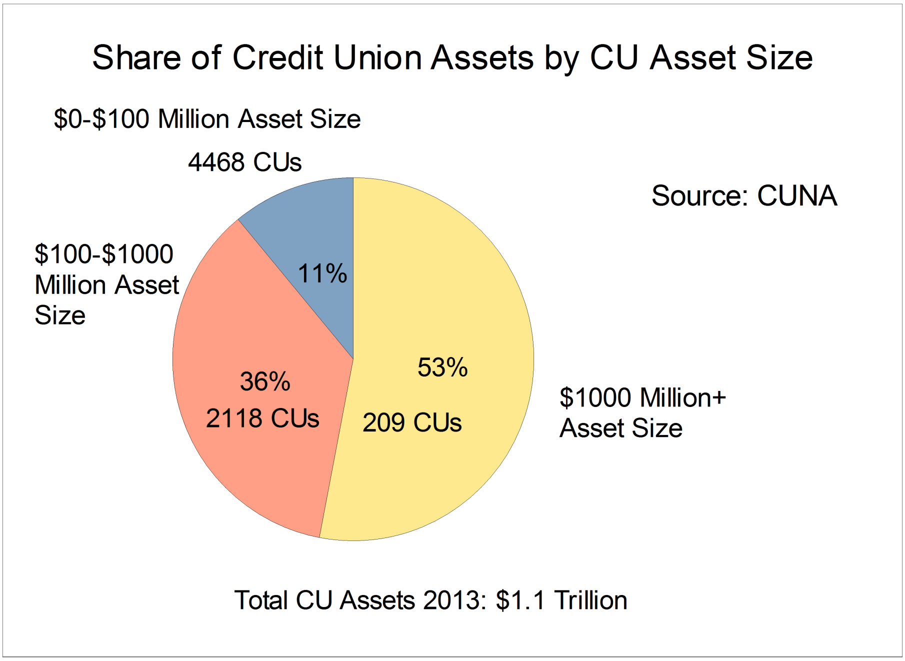
The origin of our name:

Small arms, artillery, gun carriages, ammunition and gunpowder used to be assembled, stored and issued in the 1800s at the worksite of NGA's current home along the banks of the Mississippi River. As a result, this site became known as the "St. Louis Arsenal," and we derived our name from that historical reference since NGA was our original sponsor group.

NGA is a combat support agency of the U.S. Department of Defense. Its primary mission is collecting, analyzing and

distributing geospatial intelligence in support of national security.

By 2014, the number of credit unions had shrunk by more than two thirds, and consolidation was continuing with the number of credit unions decreasing by some 4 percent each year. This was equivalent to the loss of a credit union each business day. Most of this decline was due to small credit unions with stagnant or declining membership merging into more robust institutions. Overall, the movement's growth in membership and assets has been among the bigger credit unions. In 2013, the 2,327 largest credit unions – with $100 million in assets and above – held 89 percent of the movement's assets.



Some see this trend as both desirable and inevitable. They include Henry Wirz, CEO of $2-billion SAFE Credit Union in California. Noting that many small credit

unions are losing members, he argues that: "Thousands of credit unions are failing to meet member needs and are no longer relevant to their members. Members are voting with their feet." [4]

Joy Cousminer, CEO of Bethex Federal Credit Union in New York City, a $22 million credit union serving a low-income population in the Bronx, disagrees. Cousminer notes that most credit unions serving minorities or low-income groups are small, as are "faith-based" credit unions organized by religious groups.

In remarks to the Partnership Committee of the Credit Union National Association in November, 2013, she said that: "(Small credit unions) are a quickly shrinking group. In a frightening trend that shows no concern for asset size, in the last 36 months there have been 669 mergers while only six new charter applications have been received and a mere three new charters granted. Yes, that is only three new credit unions beginning operations! If this rate continues, and there is no reason to believe it will not, there will be fewer than 6,000 credit unions left by year end 2016."

Cousminer told of two groups that have shown small credit unions are successfully resisting the trend, "We Care 4 CUs" in New York and "the "Faith Based Credit Union Alliance" in Illinois. "Since their formation in 2010," she told the committee, "no Illinois or New York faith-based credit union has been shuttered."

She made a number of recommendations for preserving small credit unions. They included (a) finding cost-effective ways for them to expand their offerings, (b) regulatory relief, (c) better training for new examiners in dealing with small credit unions, (d) less red tape in chartering new credit unions, and (e) making it easier for small credit unions to expand their fields of membership.

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4 E-mail to author, 2014.

The regulatory burden appears to be a major factor in triggering mergers. A 2014 study sponsored by the Filene Institute found that regulatory burdens figured in more than half of mergers.

As Pamela Stephens, CEO of $57 million asset Security One Federal Credit union, Arlington, Texas, told Congress in April 2013, "Part of the issue is, small institutions have the same burden as a billion-dollar institution....At Security One, we don't have any one person who is dedicated to that. We are too small to hire someone to handle compliance, so my vice presidents and I do that work. We do the research. I am the one who sits up at night reading regulations and trying to understand them. I think the answer is, Security One maybe doesn't need to be regulated along the same lines as a Bank of America, for instance. I can't envision their president sitting up at night reading the regulations."

Four months later, Security One announced that it planned to merge with $759 million Texas Trust Credit Union in Mansfield, Texas. Regulatory burden was not the sole reason; although its balance sheet was sound, the credit union had had financial reverses during the Great Recession and had lost some members. "Competing in today's financial market is challenging, Stephens said. "In order to remain competitive and continue to deliver low rates for our members, we determined the best solution for our members was to merge with another credit union."

The National Credit Union Administration, the federal regulatory agency, has tried to help smaller credit unions. In 2013, the NCUA recast the definition of "small" from "under $10 million in assets" to "under $50 million in assets." The new definition included two-thirds of U.S. credit unions. The aim was to relieve them of some of the regulatory burdens imposed on "large" credit unions.

The NCUA also has an Office of Small Credit Union Initiatives to work with smaller credit unions. In addition, the Credit Union National Association and its member state leagues have offered various programs of assistance.

Some larger credit unions offer assistance of various kinds as well, such as donation of used equipment and mentorship. However, the larger credit union must understand the smaller credit union's specific needs and work cooperatively to tailor its assistance to those needs or the help will go to waste.

According to Lisa Terrill of NCUA's Office of Small Credit Union Initiatives, "We have mixed results in establishing mentorships -- the biggest obstacle being a small CU's fear of receiving assistance from a larger CU, assuming motives of the larger CU can't possibly be anything other than to gobble up the smaller institution."

"We have done (mentorships) in the past with small (2-5 million assets) CUs" according to Nathalie Williams, of Port Alliance Federal Credit Union, Norfolk, Virginia. "The key is that the bigger credit union (we are $88 million) has to be sincere in wanting to actually help the other credit union and have respect for the smaller CU. They may be small, but if they survived the past 5 years they deserve respect just for the fact that they're still around!

"There can be no ulterior motive (merger), so the bigger CU has to communicate that (and be sincere about it)! I did this when (I was invited) to a meeting for small CUs....I knew when I saw the list of attending CU's that it would look like we were sharks circling the tank. So I addressed that immediately. I came with some solutions and offered help. We ended up helping 2 or 3 other small CU's that day and made some real connections and maintained healthy relationships with others long term--

we even sold them some loans just to help them out financially since their biggest struggle was lack of loan demand.

"There has to be trust, as with any relationship. But more importantly, to get to that place there must be R-E-S-P-E-C-T. That's the secret ingredient."

The year 1995 saw a new phenomenon – a credit union switching to a savings and loan charter. This was Lusitania Federal Credit Union in New Jersey. The event was followed sporadically by conversion of some three dozen other credit unions over the next 15 years, some of considerable size, but still a very small proportion of the total credit union movement. Most first converted to mutual charters, which are theoretically member-owned, but then eventually converted to stock charters in which members no longer had any claim to ownership.

These conversions aroused considerable controversy in the credit union movement, raising fears that the conversions were detrimental to member interests and stirring charges that the main reason for them was it gave management and directors opportunities to enrich themselves.

Regulators introduced stiffer requirements for such conversions. It appears that few credit unions are contemplating this route. The conversions have been somewhat counter-balanced by credit unions adding to their assets and memberships by acquiring small banks.

Chapter 3

Credit Union Culture and Philosophy

As outlined in the author's *Development of the Modern U.S. Credit Union Movement 1970-2010,*[5] the growth of the movement over the past 40 years or so has forced a change in the culture of most credit unions. The volunteer-centered culture of the early movement has been characterized as "populist" by historian Ian MacPherson[6]

"The populist credit union...meant the virtually complete control of credit unions by the volunteer leadership," according to MacPherson. "....The preferred credit union was small and catered to limited and specific needs – it meant extensive education programmes, informal lending practices, frequent social activities, and collegial decision-making among people who knew each other well. It often worked best among groups of employees who understood each other's needs and frailties so well they could build effective organizations based on that knowledge."

While still governed by volunteer boards, most credit unions have come to rely heavily on paid staff with specialized knowledge – whether a CEO, a teller accepting deposits and dispensing funds, a marketing professional, or a compliance officer familiar with the dozens of state and federal regulations affecting the organization. MacPherson calls this the "managerial culture."

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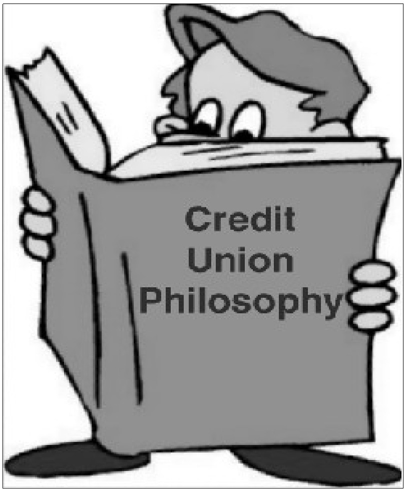
5 2013, lulu.com.

6 *Hands Around the Globe,* 1999, Horsdal & Schubart Publishers Ltd and World Council of Credit Unions.

From the beginning, this evolution has created controversy and rifts within the U.S. credit union movement. Leaders who spent their careers in the populist culture often bemoaned what they saw as a drift away from the original spirit and purpose of the movement, and they warned that credit unions were becoming just another financial institution. Meanwhile, a new breed of leaders emerged, "more professional, more educated, more experienced in financial management and more sophisticated in political affairs," wrote Dorfman in the early 1980s.



The controversy over the effects of growth continues in the pages of credit union publications as some credit unionists bewail the loss of "credit union philosophy" while others argue that credit unions remain devoted to their creed of "not for profit, not for charity but for service." While it is certainly true that relationships with members have become more diluted, the tradeoff is that the modern credit union is capable of serving a much wider range of members and member needs – whether financial counseling, convenient branch locations and mobile banking, or sophisticated financial products.

Steel Valley Federal Credit Union CEO David K. Lawhun notes that, "The sad thing is losing the mom-and-pop credit unions. It's sad because it's the small credit unions that know you personally. You know the

member, you know their family. You're not just a number. You're someone."[7]

However, members of merged small credit unions enjoy better service, noted three economists who studied nearly 300 merger participants during the 1988-1995 period.[8]

Of course, credit unions are not alone in consolidating. Agricultural cooperatives have been consolidating over the last few decades to meet the increased demands of a global marketplace. The banking industry as a whole has been rapidly consolidating.

What Is Credit Union Philosophy?

Credit union philosophy is encapsulated in such slogans as "Not for profit, not for charity," "People helping people," and "Where people count more than dollars." But those involved in credit union work can, and often do, disagree about what those terms mean in practice. To help clarify these concepts, credit unions around the world have developed a set of International Credit Union Operating Principles founded in the philosophy of cooperation.

"At the heart of these principles is the concept of human development and the brotherhood of man expressed through people working together to achieve a better life for themselves and their community," as the World Council of Credit Unions puts it. Here is a condensed version of the operating principles.

DEMOCRATIC STRUCTURE

Open and Voluntary Membership

Membership is voluntary and open to all within the accepted common bond of association.

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7 *Crains Cleveland Business* 3/19/2012.

8 *The impact of mergers on credit union service provision*, Fried, Lovell, Taisawarng, Journal of Banking and Finance, Feb. 1999, Vol. 23. Issue 2-4, p367-386.

Democratic Control

Credit union members enjoy equal rights to vote (one member, one vote) and participate in decisions affecting the credit union, without regard to how much they have on deposit or how much business they do with the credit union.

Non-Discrimination

Credit unions don't discriminate against anyone because of race, beliefs, ethnicity, or gender.

SERVICE TO MEMBERS

Distribution to Members

To encourage thrift a fair rate of interest is paid on savings and deposits, within the capability of the credit union. The surplus arising out of the operations of the credit union belongs to and benefits all members.

Building Financial Stability

A prime concern of the credit union is to build the financial strength, including adequate reserves and internal controls, that will ensure continued service to membership.

Service to Members

Credit union services are directed to improve the economic and social well-being of all members.

SOCIAL GOALS

On-Going Education

Credit unions actively promote the education of their members, officers and employees, along with the public in general, in the economic, social, democratic and mutual self-help principles of credit unions. The promotion of thrift and the wise use of credit, as well as education on the rights and responsibilities of members,

are essential to the dual social and economic character of credit unions in serving member needs.

Cooperation Among Cooperatives

Credit unions actively cooperate with other credit unions, cooperatives and their associations at local, national and international levels.

Social Responsibility

Continuing the ideals and beliefs of cooperative pioneers, credit unions seek to bring about human and social development.

The Credit Union Social Mission

The final item on this list, "Social Responsibility," deserves special consideration. Many credit unions, in addition to their task of serving members well, look to a larger horizon.

The Hebrew prophets linked righteousness and justice.

There is a strong Judeo-Christian tradition of seeking social justice – that is, working to build a more just and humane society. Credit unions fit squarely into that tradition.

The Hebrew prophets, we're told, linked two concepts: righteousness and justice. Righteousness was having a right relationship to God. Justice was having a right relationship to others.

One could not be right with God if one was unjust toward others. Zechariah told his people, "Judge with true justice, and show kindness and compassion toward each other. Do not

oppress the widow or the orphan, the resident alien or the poor."

Jesus expressed the relationship between righteousness and justice when he said, "The first and greatest commandment is to love God with all your heart and all your soul, and the second is like unto it, love your neighbor as yourself."

The concepts of righteousness and justice are still relevant. For those who are not religiously inclined, we can define righteousness as valuing those things that are worthy – truth, honesty, beauty, love, compassion – ideals that hopefully form what Martin Luther King Jr. called the content of our character. Those ideals lead to a desire to seek social justice.

The founders of the credit union movement were men and women of faith and/or high ideals, and they sought to alleviate social ills by providing honest and reasonably priced financial services through institutions owned and governed by those using them.

A Catholic layman, Alphonse Desjardins, put his church's social teachings into practice by organizing the first credit union in North America in his home in the Quebec town of Levis. The first U.S. credit union, St. Mary's Bank, was organized by a priest with Dejardins' help. For his work, Desjardins was made a Knight of St. Gregory in 1913 by Pope Pius X, who had started a credit union himself when he was a priest.

Edward A. Filene, the Boston merchant and philanthropist who bankrolled the early U.S. movement, was a non-practicing Jew who inherited the ethical tradition of his people. He became a social reformer in many fields, but his most successful and long-lasting achievement is today's movement serving 100 million Americans.

A young woman of high ideals, Louise McCarren (she later took her husband's name of Herring), graduated from the University of Cincinnati. It was the Depression, and she couldn't find a job in her male-dominated field of commercial engineering. She took a job with Kroger's and saw the struggles of employees, who often turned to "bucket shops" – the era's version of payday lenders – to get loans.

In response, she organized 13 credit unions among Kroger's workers, went on to help found the Credit Union National Association and the Ohio Credit Union League, and in all organized some 500 credit unions.

We could go on listing other men and women who spread the word about credit unions with a missionary spirit – including many actual missionaries like Father Marion M. Ganey, S.J.

He went to British Honduras in 1943 and found that loan sharks were charging rates up to 100 percent per month. He began organizing credit unions. One loan shark complained that Ganey was an imposter. "I have looked everywhere in the Christian Bible," he told the bishop, "and nowhere do I find the word 'credit union.'"

As noted above, the evolution from a populist culture to a managerial one created controversy and rifts within the U.S. credit union movement. It is true that some of the missionary spirit has gone out of the movement and that many credit union employees probably see their work more as a job than a vocation. But that does not mean that they don't believe in and savor the ideals of the movement.

Those who have worked in a bank or savings and loan often remark that the credit union attitude is very different from the profit-oriented mentality of their former employers. "It's the difference between night and day,"

one teller told the author. "I really love credit union philosophy."

Just as an individual should have a "moral compass" that steers him or her in an ethical manner, I would suggest that credit unions need a "philosophical compass" that keeps them on the right path.

This compass would point to the pole of honest, reliable service to members and community and away from staff convenience, profit-maximization, and self-aggrandizement. There is considerable evidence that many, even most, credit unions possess such a compass. Credit union web sites feature frequent references to the cooperative nature of credit unions and the goal of serving members.

The credit union trade associations on the state and national level have attempted to preserve the movement's dedication to service through education, various programs honoring philosophy in action, and encouraging community service by credit unions.

One program initiated by the Credit Union National Association has credit unions subscribing to a Statement of Commitment to Members. It has been adopted by hundreds of credit unions, many of them large ones. Another program, initiated by CUNA Mutual Insurance Group but now independent, is the National Youth Involvement Board (NYIB), which among other things, sends credit unionists out into classrooms to educate young people about finances and cooperative credit.

Another program that has trained hundreds of U.S. credit unionists in the ideals and purposes of the movement is the Credit Union Development Education (CUDE) program of the National Credit Union Foundation. (The author is a CUDE graduate.) This program has become the model for similar programs

elsewhere, such as the United Kingdom, the Caribbean, the Philippines, and Africa.

An ongoing debate concerns what credit unions, whose membership, as noted, has become largely middle-class, should be doing on behalf of low-income Americans, those on the economic margins. Critics complain that mainline credit unions ignore those most in need of their services. However, many mainline credit unions do have low-wage members and have extended their service areas to include low-income communities.

There is a group of more than 1,800 credit unions, many of them small, that have made social justice their particular mission. They are classified by regulators as "low-income credit unions" because more than half of their membership is of low income according to 2010 Census data. Many specifically have as their goal serving people left out of the American mainstream who are struggling financially. They are often organized by churches or by social reformers.

Many low-income credit unions have taken the label of "community development credit unions." They have their own association, the National Federation of Community Development Credit Unions (NFCDCU), that has helped to give low-income credit unions influence in the movement and in government that they otherwise would not have.

One of the most prominent community development credit unions is Self-Help Credit Union in North Carolina, which serves almost 39,000 members nationally, both online and through 14 branches across North Carolina. Its CEO, Martin Eakes, has long been a crusader on behalf of the poor and has fought to regulate and in some cases ban what he considers predatory lending.

The community development credit unions have sometimes come under criticism by the mainline movement as

following a path that is not economically sustainable. "Poverty makes a poor common bond," the criticism goes, the idea being that to be financially strong, a credit union needs to have members of varied income levels. On their part, low-income credit unions have criticized the main-line movement as neglecting the needs of the poor and struggling.

The mutual recriminations are not particularly helpful. The two camps have much to learn from each other. Each credit union has its own role to play in meeting the needs of poorer Americans. Some mainline credit unions do serve many low-paid workers. Some have broadened their fields of membership to include low-income neighborhoods. Many provide services to help struggling members, such as loan consolidations, loan modifications, and financial counseling, as well as contributing to charities such as children's hospitals and the National Credit Union Foundation.

Larger credit unions can often do much because they have the resources. Simply by providing lower- and middle-income members with honest, reasonably priced financial services, mainline credit unions are saving them billions of dollars each year and in their modest way ameliorating the growing "wealth gap" in our nation.

Chapter 4
Operation of the Credit Union

A credit union is a "depository" institution. That means it accepts savings of its members for safekeeping. Commercial banks, savings and loans, and savings banks are also depository institutions.

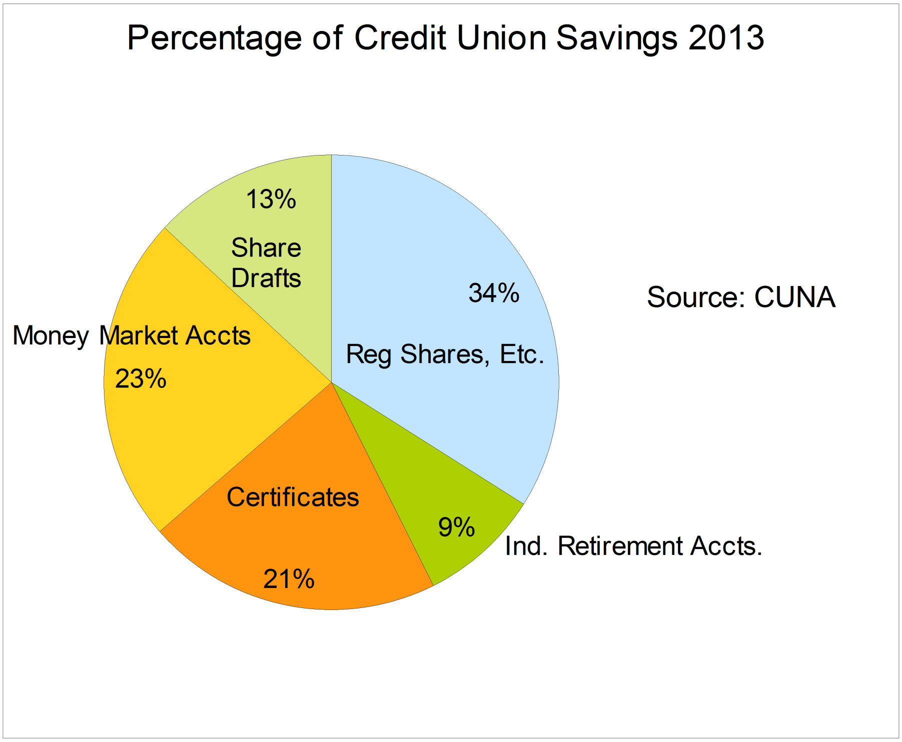
Credit union savings can take various forms:

- Regular shares. This is the traditional savings account that you open when you join the credit union and pay in $5, $10, or more.
- Share drafts (checking).
- Share certificates (CDs).
- Individual Retirement Accounts (IRAs).
- Money market accounts.

In addition to individual member savings, the credit union often may accept deposits from member businesses and from governmental bodies. Credit unions serving low-income members may receive deposits from foundations, charities, etc., although limits are placed on such deposits.

The credit union does not simply stash deposits in its vault. It only keeps enough money on hand to meet member withdrawals. It invests most of its deposits in loans to members. In return for the use of your money, the credit union pays you dividends (interest) on your savings. Credit unions have various ways of figuring the

interest on your savings, but are required by law to use a uniform method to provide you with what is called the "Annual Percentage Yield," or "APY." This allows you to compare the credit union's APY with that of other places where you might deposit your money.



Lending

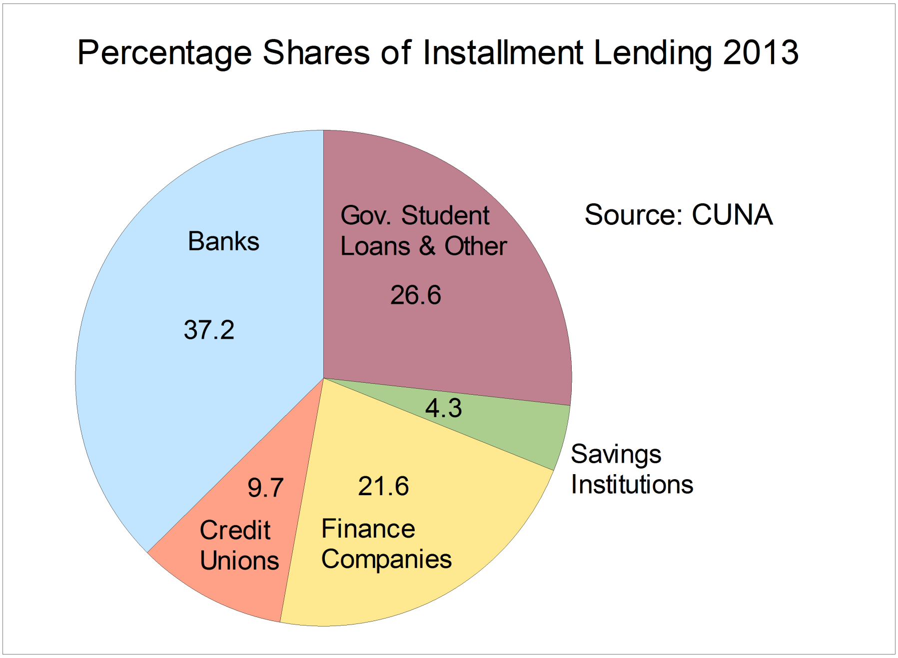
In most credit unions, lending is in the hands of a loan officer, a staff member. In very small credit unions, it may be the responsibility of a credit committee made up of several members.

Credit unions make two main types of loans:

"Secured loans" such as vehicle loans and home mortgage loans. If these loans are not repaid, the credit union can seize the car or home.

"Unsecured loans" such as credit card loans. If the member defaults, there's nothing the credit union can do to get its money back without going to court. For this reason, unsecured loans generally carry a higher interest rate than secured loans, due to the greater risk of loss.

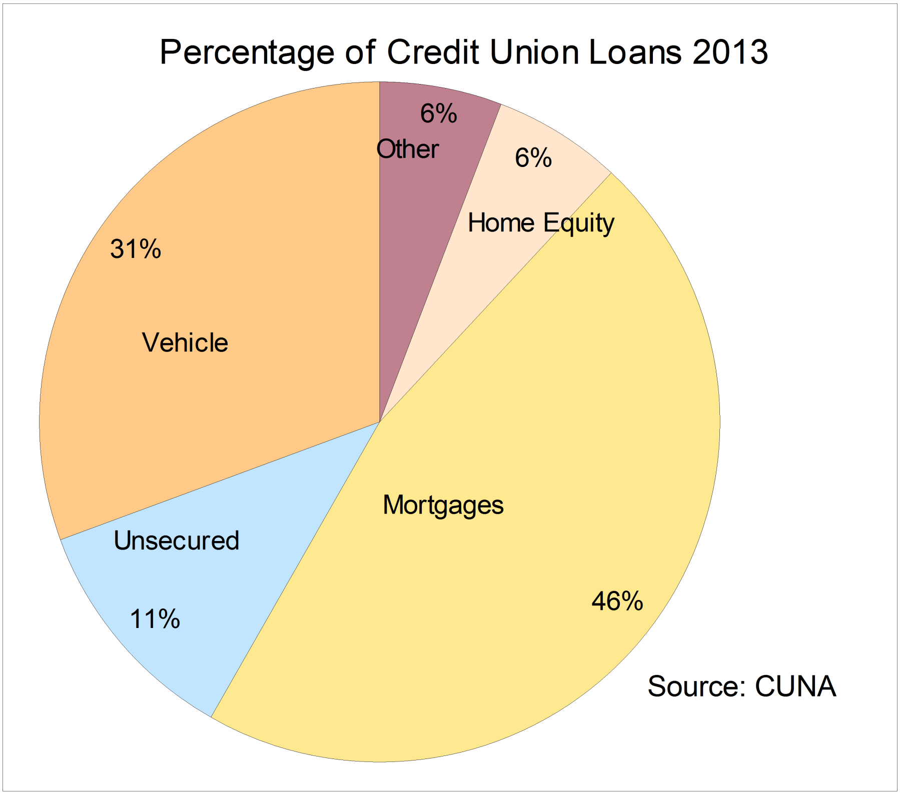
Another way to classify loans is to divide them into "revolving" and "non-revolving" or installment loans. Credit cards represent the first type of loan. The member does not have to pay off the loan on any fixed schedule except to make a certain minimum payment each month. A home mortgage loan is a non-revolving or installment loan. It's paid off in installments over a fixed number of years.



Credit unions have long been major players in the vehicle loan market. Much of this lending is done indirectly through auto dealers, who act as agents for the credit union. "Today more than 80% of all auto loans are

written at the dealership," notes Henry Wirz, CEO of SAFE Credit Union in California.[9]

Mortgage lending is even more important in credit union lending. The credit union may elect to hold these loans or resell them on the national market for such loans, in order to get funds to make more loans.



Most loans are for personal use. But many credit unions make small business loans, such as a loan to someone building a small apartment house. Credit unions also can make "participation loans" – making a loan and selling parts of the loan to other credit unions. This enables a credit union to offer larger loans than it could

9 E-mail to author, 2014.

make if it held the loans in its loan portfolio. On the flip side, the credit union may participate in loans made by other credit unions.

When a member asks for a loan, the loan officer must judge whether he or she is likely to repay the loan. One tool for this is the member's record of repayment of previous loans. Another is looking at the financial condition of the member, such as annual income, home ownership, outstanding debts, etc. Still another is the member's "credit rating."

Credit ratings are provided by three different national companies. Stores and other businesses, along with financial institutions, provide these companies with information about how you and I have handled debt. One of the most common ways credit ratings are expressed is through what is called the FICO score, developed by the Fair Isaac Corporation. FICO scores range from 300 to 850. According to Fair Isaac, the median FICO score is 723. The best rates tend to go to borrowers with FICO scores above 740.

The amount of the loan is called the "principal." When a member borrows money from the credit union, he or she pays on the principle until the loan is repaid. The member also must pay interest on the unpaid portion of the principal.

Sometimes members fall behind in their loan payments. A loan that is two months or more behind the repayment schedule is called "delinquent." Most delinquent loans are eventually repaid. However, if the member does not repay the loan, even after efforts to collect the amount, the loan is said to be in default. The credit union has to "charge off" the loan – that is, treat it as a loss.

The credit union must walk a fine line between lending prudently and tightening lending requirements to the

point where members can no longer get the credit they need.

Many credit unions offer "risk-based lending." The interest rate on a loan varies depending on the credit score of the member. A riskier loan is charged a higher interest rate to balance the possibility of loss. Some credit unions believe all members should be treated alike, but risk-based lending allows a credit union to serve members who may not have the best credit score.

If a member has a bad credit score, the credit union may offer him or her a chance to demonstrate credit-worthiness by building up savings and then borrowing a small amount against the savings and repaying it on time. This kind of "credit builder" loan can be a lifesaver to a member seeking to rebuild his or her credit.

The "Spread"

The interest borrowers pay is higher than the interest paid to members for their savings. This difference is called the interest rate "spread." For instance, if the credit union pays an average of 2 percent interest on savings and charges an average of 5 percent interest on loans, the spread is 3 percent (5 minus 2).

Other expenses and income can be added into this calculation, giving the credit union a total spread figure. In 2013, the nation's credit unions had a net spread of 1.03 percent. The spread is often expressed in terms of "basis points," each point representing one hundredth of

a percent. In other words, 1.03 percent would be 103 basis points. The net spread is the way the credit union earns money to keep operating.

Since the Great Recession, with the Federal Reserve keeping interest rates close to zero to stimulate the economy, it has been difficult for credit unions to maintain an adequate spread between lending and saving interest rates. They have been forced to rely on fee and other income to keep their total spread sufficient to maintain earnings.

Investments

Member savings not loaned out are largely invested in low-risk places, such as banks, government securities, and the like. The credit union usually earns more on loans than it does on investments, so it has an incentive to loan as much of its members' savings as is possible and prudent.

The percentage of member money loaned out is called the "loan to share ratio." (As noted earlier, member savings are called shares, because they represent member ownership of the credit union.) The loan-share ratio is one way to judge the lending operations of the credit union. In 2013, credit unions on average had 71 percent of their member savings loaned out to members. Another measure is the loans outstanding to assets ratio, which measures the effectiveness of the credit union's use of its assets. In 2013, credit unions on average had a loan to asset ratio of 61 percent.

There is a generational aspect to all this. Older credit union members have built up savings over the years and paid down many of their debts like mortgages. Their prime tie with the credit union is as a safe place to keep their funds and earn a return on them. Younger members, on the other hand, are starting out with little in savings but needing loans for such things as cars, hous-

es, and household goods. They see the credit union mainly as a source of credit.

One task for the credit union is to attract a mix of young and old members so there is a balance of needs. Like the U.S. population in general, the average age of U.S. credit union members has been creeping up, challenging credit unions to find ways of attracting younger members.

Besides income from loans and investments, a credit union earns money from various fees, such as a penalty for bouncing a share draft (check) or a small charge for counting coins. However, credit union fees historically have been fewer and lower than bank fees.

What Does the Credit Union Do With Its Income?

Out of its earnings, the credit union must cover:

- Interest payments to its savers.
- Interest on any money the credit union has borrowed.
- Operating expenses, such as salaries and benefits, supplies, equipment leases, mortgage payments, electricity, heat, repairs, etc.
- Loss provisions, i.e., expected losses on loans and investments.

Subtracting these expenses from income gives us the "net income" or "profit" of the credit union. For corporate tax purposes, credit unions are classed by the IRS as "nonprofit" institutions like certain hospitals and the YMCA. This makes them exempt from corporate income tax. But like those other institutions, credit unions must earn at least a small profit to stay in business. That's why many credit unionists prefer to use the term "not-for-profit," rather than "nonprofit."

How does the credit union use its net income? It usually puts part of it into its reserves, which are funds set aside

to provide a financial cushion against hard times. The fact is, ever since our nation's founding, we have had periodic financial "panics," i.e., recessions or depressions, that slow economic activity, increase unemployment, and cause difficulties for financial institutions. Bill Myers, a former community development credit union CEO and now director of NCUA's Office of Small Credit Union Initiatives, notes that:

"The United States has had a continual series of banking crises during its history....The Great Depression generated a historic peak in bank failures in 1933 when 4,000 banks closed and their depositors lost their money. That round of failures led to the implementation of deposit insurance. Yet, banks continued to fail: in 1937's post-depression, the savings and loan crisis of the 1980s and 1990s, and recently, the financial crisis of 2007-2009. Why is banking so problematic? All the wins and losses in the economy flow through the financial sector. There is great opportunity to participate in wins, but every loss has to be absorbed as well.[10]

Panics occur on average about every decade or so, some with little impact and others with sledgehammer effect. It is the wise credit union that has a good cushion of reserves.

Once additions to reserves are made, the rest of the earnings can be used to grow the credit union, improve member services or to pay back to members in the form of lower loan rates and higher rates on savings.

The credit union keeps track of its income and expenses through what is called a "statement of income." This is done on a monthly, quarterly, and yearly basis, and it is provided to members in the annual report.

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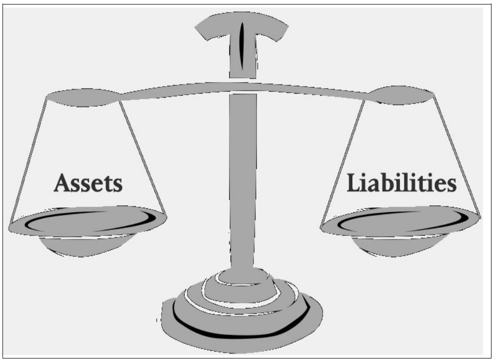
10 March 2014 *Focus,*newsletter of the Office of Small Credit Union Initiatives.

Balancing Act

It was in late medieval times in Italy that merchants found a way to keep track of the financial condition of their businesses through what is called "double-entry bookkeeping." This system divides the finances of a credit union or other business into "assets" and "liabilities."



Assets include everything that the credit union owns or expects to receive. The major assets of a credit union include loans to members, investments, and buildings and equipment owned by the credit union.

Liabilities are what the credit union owes to others. Major liabilities include the savings of members (since they are owed to members), what the credit union owes its creditors, and the financial reserves set aside for a rainy day (called member equity), since those reserves belong to the members, not the credit union.

The way the system works is that at the end of every accounting period, assets should exactly equal liabilities. If they don't balance, something is wrong. The statement of assets and liabilities is called the "balance sheet" or "statement of financial condition."

Reading Financial Statements

The statements of income and financial condition give the credit union board, staff, and members a way of judging how their credit union is doing. A healthy financial statement helps to show that the credit union is meeting the needs of its members. It also says something about the board and the hired leadership of the credit union.

Perhaps the most important single indicator of credit union financial health is what is called the "return on assets," or ROA. This compares net income and average total assets. "ROA provides insight into how efficiently a credit union is being run by management and their ability to generate profits from the assets available to the credit union," notes Callahan and Associates, a consulting firm.

For depository institutions, a net income equal to 1 percent of assets has historically been a measure of adequate profitability. In recent years, with the Great Recession and its fallout, financial institutions, including credit unions, have faced financial headwinds and found it hard to hit that mark. In 2013, credit unions had an average ROA of 0.79.

ROA is not the end all-be all of financial health, Callahan and Associates points out. "In the credit union industry context, however, ROA needs to be viewed in light of each credit union's unique strategy. For example, if a credit union's strategy is to pass along potential profits to its members (i.e. no fees, high deposit rates, low lending rates), its strategy may result in a low ROA relative to its industry peers."

Other Key Indicators

Capital

Every credit union needs to have reserves to cushion it against financial shocks like unexpected losses, recession, or loss of a sponsor. Other terms for such

credit union reserves are "net worth," "retained earnings," "member equity," or "capital." Banks can raise capital by selling stock to the public. This option is not available (at least for now) to credit unions. When a credit union is chartered, it begins operation with zero capital. It gradually accumulates capital by putting some of its net income (profit) into reserves.

The customary way to measure whether credit union capital is adequate is to compare it to total assets: i.e., dividing capital by total assets. This yields a percentage figure. Credit unions in 2013 were generally well-capitalized, with an average capital to asset ratio of 10.5 percent. If capital falls below 7 percent, the regulator will step in to insist on remedies. Some experts argue that credit unions are "over capitalized," that is, some of their capital could be put to better use in credit union operations. However, in times like the Great Recession of 2007-2009, capital provided a strong shock absorber that enabled many credit unions to ride out the bumps.

Productivity

Is the credit union making efficient use of its resources? There are a number of measures of productivity. One is the number of full-time employees for each million dollars in assets. The average for all credit unions in 2013 was 0.24. Another measure is number of members per each full-time employee. In 2013, this stood at 386 members.

Growth

Is the credit union growing, standing still, or shrinking? To determine this, we look at assets, membership, and savings and loans from year to year. In general, credit unions, especially larger ones, have been seeing accelerated growth in recent years. A credit union that is not growing may become a candidate for liquidation or merger with another credit union.

Quality of Assets

As we have seen, the two most important assets a credit union has are its portfolio of loans and its investments. The quality of loans a credit union has made can be determined by looking at loan delinquencies (loans two months or more behind in payments) and charge-offs (loans that the credit union has given up on collecting). In 2013, only slightly more than 1 percent of credit union loans outstanding were delinquent, a sign that borrowers were doing a good job of repayment. Charge-offs were even lower, with only 0.57 percent of loans being counted as lost causes.

These figures represent a decline from the Great Recession. In 2009, for example, delinquent loans represented 1.8 percent of all loans, and charge-offs stood at 1.21 percent.

Some credit unionists believe that credit unions should be accepting a higher degree of risk in lending to reach out to less creditworthy members. As we have noted, many credit unions are using risk-based lending to try to do this. However, each credit union must determine for itself what degree of risk to accept in lending. In general, regulators prefer lower delinquency rates when judging credit union safety and soundness.

There is no easy way to determine the quality of the credit union investments except to look at the types and lengths of investments. Regulations prohibit credit unions from making what the regulator considers risky investments, but no investment is completely without risk.

Is the credit union investing its excess funds in very safe government securities and depositing them in high-quality financial institutions? Is it pushing for the highest possible return on its investments? This means accepting more risk. The curious member can explore

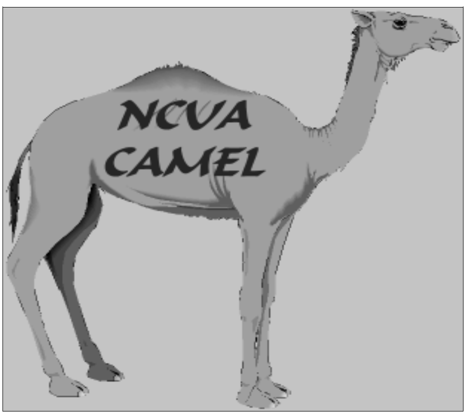
this further by talking with the credit union's chief financial officer.

Safety and Soundness

Ever since the federal government in 1970 began insuring credit union deposits against loss, a major task of the National Credit Union Administration (NCUA) has been to examine credit unions regularly to try to ensure that they do not pose a risk to the National Credit Union Share Insurance Fund (NCUSIF).

Examiners visit an insured credit union every year or so and go through its books and management practices to determine the safety and soundness of the credit union. For very large credit unions, examiners may stay on-site throughout the year. For state-chartered credit unions, federal examinations are carried out in coordination with state examiners.

A credit union examination looks at five different areas:



- **C**apital adequacy.
- **A**sset management.
- **M**anagement
- **E**arnings
- **L**iquidity/Asset Management

The first letters of these categories spell out CAMEL, and that's the name of this rating system

Each of these five areas is scored from 1 to 5, with 1 being the top score. The examiner then gives the credit union an overall CAMEL rating of from 1 to 5. This is what the overall ratings mean:

- **Rating 1** - Credit unions in this group are sound in every respect and generally have components rated 1 and 2. Any weaknesses are minor.
- **Rating 2** - Credit unions in this group are fundamentally sound. For a credit union to receive this rating, generally no component rating should be more severe than a 3. Only moderate weaknesses are present.
- **Rating 3** - Credit unions in this group exhibit some degree of supervisory concern in one or more of the component areas. These credit unions require more than normal supervision, which may include enforcement actions. Failure appears unlikely, however.
- **Rating 4** - Credit unions in this group generally exhibit unsafe and unsound practices or conditions. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.
- **Rating 5** - Credit unions in this group exhibit extremely unsafe and unsound practices and conditions. Ongoing supervisory attention is necessary. Credit unions in this group pose a significant risk to the insurance fund, and failure is highly probable.

The CAMEL rating is given to the board and manager of the credit union, under the condition that it be kept confidential. In other words, neither members nor the general public are informed. The reasons given for this secrecy include:

- Release of a poor CAMEL rating could result in a "run" on a credit union – i.e., members rushing to withdraw their funds. Or, at least it could

encourage members to shift their business to a credit union with a stronger CAMEL rating.

- If some credit unions release their CAMEL scores and others do not, will the press and public infer that those who do not are unsafe?
- If a credit union's CAMEL rating declines over time, would this affect how members perceive their credit union?

Some credit unionists believe that CAMEL ratings should be made public. They argue that this would give members a better understanding of their credit union's financial and management health. They believe the benefits of fuller transparency for members outweigh the risks of disclosure.

In 2011, a major state-chartered credit union in North Carolina tested this proposition. State charters receive two CAMEL scores, one from NCUA and the other from their state regulator. Ordinarily, the the two authorities are not far apart in their appraisals. State Employees Credit Union (SECU), the nation's second largest credit union, with more than $25 billion in assets, got permission from its state regulator to reveal its state CAMEL score: 2.

Its CEO, Jim Blaine, known in the credit union world as an outspoken and thought-provoking leader, justified this act as an experiment in transparency. NCUA was not amused. It put considerable pressure on the state regulator's office and persuaded it not to repeat the experiment.

There is a widely used rating service, Bauer Financial, Inc., that looks at the financial information credit unions must submit to NCUA and ranks them for safety and soundness on a five-star basis, with five stars being the highest score.

Based upon SECU's 2013 financials, Bauer Financial awarded the credit union four stars – somewhat comparable to the CAMEL score of 2 that SECU publicized in 2011. Many credit unions proudly publicize their Bauer Financial ratings. Anyone can access the star ratings by going to bauerfinancial.com. Additional information from the firm about a credit union is available at a cost. Another rating service is bankrate.com.

Chapter 5

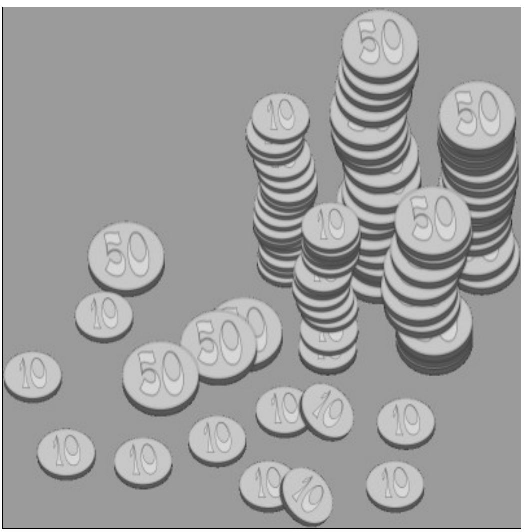
The Credit Union's Place in the Financial System

"I need a cow. I'll trade you ten sheep for one of your cows," Farmer Fred said to Farmer Daisy.

"Ten sheep! She's worth at least twelve," Farmer Daisy replied.

They settled on eleven sheep, and both were happy.

This kind of trade is called barter.



The invention of money promoted economic activity.

But what happens if Farmer Daisy doesn't want any sheep? Let's say, she'd prefer goats but Farmer Fred doesn't have any goats?

It was to deal with that sort of problem that money was invented. We don't know what the first money was made of – it probably was something useful or prized, like bits of metal or pretty sea shells, that were not too common.

Farmer Fred then could offer Farmer Daisy 100 sea shells for her cow, and they would settle on 110 shells. Farmer Daisy then could approach another farmer who had goats and pay him in sea shells.

Eventually, coins and paper money issued by governments or merchants replaced seashells and other informal money. Trading became much easier for everyone, and economic activity picked up. Money fostered long-distance trade – Frankincense from Arabia could be sold in Europe via a long chain of merchants using money in exchange with each other. As economists say, money is a "medium of exchange."

In addition to fostering commerce, the invention of coinage and paper money was very helpful to government tax collectors, who could collect in currency rather than bushels of wheat or other goods.

Somebody who accumulated money beyond his or her immediate needs could bury it for safekeeping and draw on the hoard when needed. (The author has two Roman coins recovered from just such a hoard in Great Britain.) Later, trusted merchants began accepting money for safekeeping. This was the beginning of banking. So, as economists say, money is also a "store of value."

Money has an almost mystical status in human affairs. As long as people believe in its value, it can be made of anything – iron bars, gold coins, pieces of paper like printed currency or checks, or electronic impulses stored in computers (most of the world's monetary transactions these days are done by computer).

The reverse is also true: If people come to distrust the value of their currency, prices for everything can soar (hyperinflation), often leading to economic collapse (depression). This can happen when a government consistently spends more than it receives in revenue and turns to creating more money to pay its bills. If the

government is trusted enough, this can continue for some time and produce only mild inflation. But if the world comes to mistrust the government's ability to pay its debt in sound currency, hyperinflation can result. Citizens start lugging around cash in suitcases to buy toothpaste and toilet paper. Eventually the money becomes worthless.

There is no "world currency," but the American dollar comes close. It is accepted and valued just about everywhere, and prices of commodities such as oil are denominated in dollars. This has earned the dollar the title of the world's "reserve currency." A few nations like Panama actually use U.S. dollars as their currency.

A number of West European nations have joined together in a monetary union and make use of a single currency, the euro. But most nations have their own money – the yen, rupee, ruble, or what have you. National monies are usually convertible into each other at rates set by governments or by people who buy and sell currencies. This enables a citizen of Ghana to use his nation's currency to buy an American or Japanese car. Some people have tried to invent "virtual" currencies that are not issued by governments and reside only in computers, but so far, these currencies, such as bitcoin, have not proven to be reliable.

Between buying and selling, billions of dollars worth of money flow around the world each day. This gives Americans clothing made in Thailand or the Philippines, rice from India, grapes from Peru, and skyscrapers financed by the Chinese. It also enables U.S. goods and services to be sold around the world.

The Role of Credit

Much of this economic activity would not be possible without credit. A developer wishing to build a subdivision seldom has the money on hand to do the job. He or she

goes to the bank and borrows the money needed to buy the land and build. As the buildings sell, the developer pays back the bank. Credit thus greases the wheels of the economy.

Availability of credit is essential to much economic activity, such as construction. Author Photo.

Credit in turn would not be possible without saving. Banks and other depository institutions are major players in the national and world economy. The savings entrusted to them help finance trade and investments ranging in scope from your own community to the farthest reaches of the globe.

(There are other ways of saving that bypass the banking system, such as investing in a money market mutual fund that allows you to access the somewhat higher interest rates being paid on debt instruments (bills) issued by the U.S. Treasury. Institutions and wealthy individuals can invest in things like derivatives – financial instruments based on the value of some underlying asset such as mortgages. These alternative forms of

savings (and lending) outside depository institutions comprise what is called the "shadow banking system.")

Credit unions occupy their own niche in the depository system. They specialize in consumer savings and lending. They leave most business savings and lending to the banks. Credit unions hold only around 0.6 percent of the nation's wealth (assets), but they hold some 5.5 percent of the assets of the nation's depository institutions. They hold a little under 10 percent of household savings and a little over 10 percent of consumer loans outstanding.

Apart from direct credit union services to members, research has shown that credit union competition helps keep the rates of other institutions more favorable to all consumers.

Chapter 6

Credit Union Governance

All U.S. credit unions must be chartered either under federal or state law. Those with federal charters carry the term "federal" as part of their names, as in Navy Federal Credit Union. State charters are simply termed credit unions, as in Summit Credit Union. Roughly six out of ten of the nation's credit unions are chartered under federal law.

State and federal credit union laws have evolved in tandem and are generally similar. Some state laws have "wild-card" provisions granting state credit unions all powers found in federal law. A federal credit union may switch to a state charter and vice versa

Federal credit union law is enforced by the National Credit Union Administration (NCUA), an independent agency headed by a chairperson and two other board members. State charters usually are regulated by a credit union division within the state banking or financial institutions department.

NCUA also administers the federal deposit insurance fund, the National Credit Union Share Insurance Fund (NCUSIF). Federal credit unions are required to be insured, and all but a few state charters are also insured by the fund. Those not ensured by NCUSIF usually have

private insurance. As of 2014, NCUSIF insured accounts up to $250,000.

The structure of even the largest credit unions is relatively simple. Volunteers from among the membership are elected to the board, which sets policies, oversees the operation of the credit union, and hires and supervises the manager. The board consists of a chair and other executive (table) officers, plus several other directors. Federal credit unions cannot pay their directors, although it is permitted to pay the treasurer if he or she also acts as the credit union manager. This usually occurs only in the smallest credit unions. In a few states, directors of state-chartered credit unions may be compensated but not many credit unions do this, and the compensation is usually small.

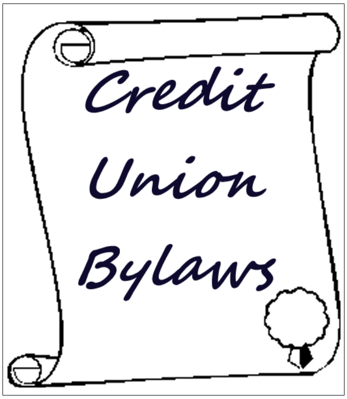
The following information deals with federally chartered credit unions. State-chartered credit unions may vary slightly in their board structure.

Boards of federal credit unions consist of from five to fifteen members – the odd number helps ensure no tie votes. Larger credit unions tend to have bigger boards. The average board has around eight members. The table officers consist of the following:

- The chair presides at board meetings and at all meetings of the credit union's members.
- The vice-chair presides in the absence of the chair. There may be more than one vice-chair.

- The treasurer is responsible for keeping track of the finances and assets of the credit union and ensuring that financial and other required reports are submitted to the National Credit Union Administration (NCUA).
- The secretary is responsible for seeing that a record of board meetings is kept.

These officers can act as an executive committee to deal with issues that arise between board meetings. In most credit unions, staff members handle the responsibilities of the treasurer and secretary, under the supervision of the directors they are assisting.



The board of a federal credit union must meet at least once a month. It reports annually to the membership as to the financial condition of the credit union and significant developments and board actions. As owners, members have the right to inspect credit union books and records, including board minutes. This must be for the purpose of ascertaining the financial health of the credit union or other worthwhile reason, not simply idle curiosity or some vexatious purpose. There may be considerable paperwork involved in getting access to the material.

Bylaws and Committees

Each credit union has a set of bylaws that govern its operations and the powers of the board. For example, the bylaws spell out the particular groups that are eligible for membership. The bylaws are the "constitution" of the credit union. They can be changed by the board with the permission of the membership and the regulator.

The board appoints committees to help it in its work. The most important committee, required by law, is the *supervisory* or *audit committee*. The supervisory committee is a watchdog group that under federal law is responsible for an annual audit and reporting the results to the board and members at the next annual meeting.

Among its other duties, it also is responsible for initiating disciplinary action against misbehaving board members and bringing their cases before the membership for action. The supervisory committee consists of three to five individuals drawn from the membership. One director may serve on the committee, but not the treasurer, and no staff member can serve.

The board may appoint other committees. Some credit unions have a *credit committee* that oversees loan policies or that, in small credit unions, may approve or disapprove individual loans. There may be a *nominations committee* to seek candidates for the board. Work on a committee can be a way for a member interested in governance to prepare for serving as a director.

There is a reason why board members are called "directors." Their job is to direct the credit union, that is, oversee it and set its overall course on behalf of the members, not manage it. That task is in the hands of the credit union manager, usually called the president or president and CEO, and the people he or she hires. The board should not be involved in day to day operations of the credit union. That's called "micromanaging" and it usually damages the credit union.

The next chapter devotes more attention to the role of the board.

Maintaining Credit Union Democracy

When credit unions were small and membership confined to one group, the idea of credit union democracy – one member, one vote – had tangible reality. The annual

meeting, at which board elections were held, could attract a large share, even a majority, of members. They often personally knew the directors and candidates. Each member could feel that his or her vote had real weight. A candidate for office could solicit support by walking around the shop floor or telephoning members. The cost of elections was minimal.

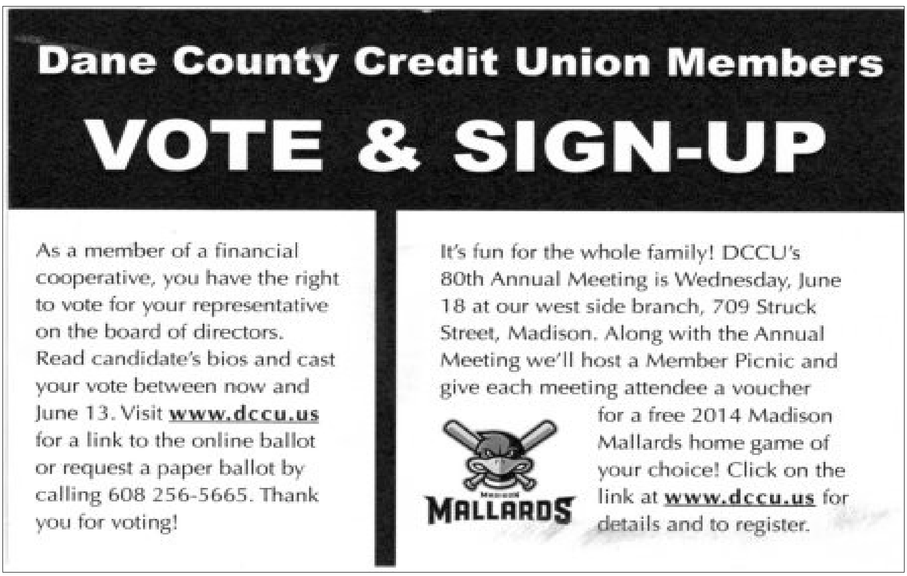
Today, when a credit union has tens or hundreds of thousands of members or even more, preserving democracy is a real challenge. The passage of share insurance in 1970 removed much of the motivation members might have to keep tabs on the financial condition of the credit union. Many members have at most a casual attachment to the credit union and have no knowledge of or interest in the board members. The annual meeting attracts but a fraction of the membership, sometimes mainly employees of the credit union. Only a minority of members bothers to vote.

In short, the movement has largely evolved from direct democracy to representative democracy in which positions are filled by votes of those who for one reason or another like to take part in elections. It has also become difficult for challengers to board policies to make their case to a large membership that may be scattered across a city or a state.

Election participation and attendance at the annual meeting can swell if the credit union is facing serious problems or some issue has caught the attention of

members. But in ordinary times, member involvement is often lackluster. There is a parallel with U.S. elections. Turnout is greatest in presidential election years, less in off-years. Primaries attract still fewer voters, and school board races may be decided by a few votes.

Henry Wirz, CEO of Safe Credit Union, is pessimistic about the prospects for credit union democracy. "I would submit that their member participation in governance is a far cry from what the first credit unions had and what is necessary to have a healthy check and balance on management and the Board."[11]



Postcard notice of election by Dane County Credit Union, Madison, Wisconsin,

However, many credit unions are seeking to strengthen member participation. They are creating techniques to attract members to the annual meeting, increase voting,

11 E-mail to author, 2014.

measure member satisfaction with services, and sound out the membership on important issues.

For example, voting usually no longer takes place at the annual meeting but is done by mail ballot, with members informed of the qualifications of each candidate for the board. The ballots are usually mailed out with members' monthly account statements and may also be handed to the member at the teller window. Results are announced at the annual meeting. In recent years, credit unions have begun turning to online voting, often using the services of an outside firm like EveryoneCounts, Inc. E-voting can be combined with paper ballots or can substitute for paper ballots, saving a good deal of money.

The effective credit union communicates with members in many ways -- including newsletters, often distributed with statements and available on the credit union's website. The best newsletters do more than push product. They educate members about credit union philosophy, offer financial advice, and report on board decisions. The credit union's annual report also conveys important information. Also, many credit unions periodically survey their membership as to their satisfaction with the credit union's service.

The most important factor, perhaps, in ensuring good credit union service is that that members can vote with their feet, simply taking their business elsewhere. This encourages staff and board to stick closely to their task of satisfying members.

Chapter 7

Toward a More Effective Board

Board members have several basic duties.

The duty of care. This means that the director should carry out his or her responsibilities with all the care, diligence, and skill that any ordinary, prudent person would use. Care includes attending meetings, listening carefully to what management reports, reading all the materials given to the board by management, asking questions about what puzzles or worries the director, and learning enough about financial matters to understand the business of the credit union. The duty of care is a legal as well as an ethical duty. Board members and other volunteers can be held legally liable when things go wrong at the credit union.

The duty of loyalty. This simply means that the director puts the interest of credit union members above self-interest. The director doesn't take actions that benefit the director, relatives, or friends at the expense of the credit union members. That kind of unethical behavior is called conflict of interest or self-dealing. For

example, the director doesn't ask the credit union for a special loan deal that isn't available to other members. Or the director doesn't try to steer the credit union to buy supplies from a store owned by a brother-in-law.

The brother-in-law might have the lowest office supply prices in town, and it might be good for the credit union to buy from him. That's okay. But the director needs to point out the conflict of interest to the board, and let the board decide what to do without his or her participation. To give another example, if the credit union is buying a piece of land, and that purchase might affect a director or a relative, the director needs to draw the board's attention to the conflict of interest and should not take part in the voting on the purchase. And the board should have good evidence on record to show that a director's interest in the deal did not bias its decision.

An attorney who served for 12 years as a credit union director neglected the duty of care. During that time, he acted as a broker in setting up several credit union mortgage loans, on which he collected fees. Ultimately, his loans resulted in a loss of nearly $97,000 to the credit union. His actions violated specific provisions of the Federal Credit Union Act, and also constituted conflict of interest. NCUA fined him $100,000 and barred him from ever serving in any capacity in any financial institution.

The duty of obedience. This simply means that the director's actions should be in line with the credit union's rules, and the director should work to advance the goals of the credit union as spelled out in its charter, bylaws, and mission statement.

None of these duties is rocket science. They're just common sense.

Board and Management Roles

The board's job is to set credit union policy and oversee management. We can start by asking ourselves – why do we have boards of directors?

- In a private, for-profit corporation, the board of directors represents the stockholders – the people who own the corporation. The directors' job is to oversee the management of the corporation and make sure the business is run for the benefit of the owners.
- In a cooperative like a credit union, the members are the shareholders and owners. The role of directors is to represent the members and make sure that the credit union is operated for their benefit.

An individual director has no special authority to intervene in the affairs of the credit union. The individual director has no more official power than any other member of the credit union, and has no right to special consideration in transacting business with the credit union. Only the board acting together in its official capacity has authority to give directions to management. Ordinarily, the board chair will be the person who deals most directly with management on behalf of the board.

The board delegates responsibility for running the credit union to the manager and staff. But the board is responsible for managing management. In other words, it's the board's responsibility to see that management is doing its job.

What directors must know

The credit union is a financial institution, and of course, directors can't oversee it effectively unless they have a basic understanding of credit union finances. (See Chapters 5 and 6.)

Another responsibility is being familiar with the dozens of relevant federal and state laws and regulations – and all the acronyms that go with them. While the director doesn't need to be a lawyer, he or she does need to know the gist of these laws and how they apply to the credit union. For instance, in hiring and firing, management and the board need to observe anti-discrimination practices mandated by law.

Directors also must know their role as board members. Generally speaking, we need to draw a line between the work of the board, and the work of management. The board doesn't have the time or usually the expertise to do a good job of running the credit union. Its work should be broad-scale, doing things management can't or shouldn't do. Broad-scale jobs appropriate to the board include approving the annual budget, establishing general policies, setting goals, and measuring management performance.

The relationship between the board and the management can become unbalanced. This can happen when a credit union has a very strong, decisive manager, who encourages the board to play the role of a passive onlooker. The board begins to let the manager take the lead in everything. It eventually can become a rubber stamp for the manager, approving the manager's ideas and actions with few questions.

Because there is no check on the manager, he or she can make costly mistakes. This kind of relationship is also an invitation to managerial dishonesty. The collapse of

Enron and some other big U.S. corporations was partly due to the fact that directors failed to question management decisions closely.

But the opposite can happen, too. The board gets into doing management's work, getting involved in routine operational decisions, not trusting the manager to do his or her job. The board ends up needing to be consulted on routine or minor purchases, low-level hiring and firing decisions, and the like. This demoralizes the manager and staff. People may get fed up and quit. Meanwhile, the board gets bogged down in details and neglects its own proper responsibilities.

Governance expert Richard Powers speaks of the NIFO approach, meaning Noses In, Fingers Out. "To the extent that the board becomes involved with everyday decisions, they undermine the CEO and they become responsible for those decisions," he notes.[12]

There can be some overlap between the two functions, especially for very small credit unions. Some small credit unions have board treasurers who are paid to manage the credit union. That used to be a very common arrangement, but it's not so common any longer. Board members may have specialized knowledge – like accounting expertise – that can be usefully shared with management and staff. But generally speaking, micromanaging is inefficient and bad for the credit union over the long run.

The ideal situation is a strong board and strong management, working cooperatively, each doing its own job.

Who guards the guardians?

As noted earlier, while the board oversees management, there's a watchdog that oversees both the board and management – the supervisory committee. The board

12 *Credit Union Management,* April 2013.

appoints the members of this committee, and fills vacancies as they occur. This is a very important function, because the committee has a number of significant duties. These can be divided into ongoing activities and annual responsibilities.

Ongoing activities of the supervisory committee include:

- Reviewing policies and procedures.
- Safeguarding member assets by overseeing internal controls.
- Reviewing credit union operations.
- Reviewing board meeting minutes.
- Evaluating management performance.
- Ensuring compliance with consumer credit regulations.
- Cooperating with regulatory agencies by providing examiners with records of the committee's work.
- Dealing with member complaints that can't be settled by management.

Annual responsibilities include:

- Surveying and evaluating internal controls.
- The annual audit, either by the committee itself or by a hired outside auditor.

Legal Liability of Directors

Directors are legally liable for their performance. Common reasons why directors are sued include mismanagement, non-management, and conflict of interest.

Some directors believe that they aren't legally liable if things go wrong at the credit union because they're unpaid volunteers, they were absent when a key board decision was made, the examiner or auditor didn't find a problem, or they didn't know what the law was or what was going on at the credit union. Unfortunately, or maybe fortunately, those excuses won't stand up in court or regulatory proceedings.

The board or individual directors can be sued by members, by credit union employees or job applicants, by regulators, or by contractors.

What might trigger a lawsuit? Members most often sue over collection policies, financial mismanagement of the credit union, or violation of member privacy. Employees or job applicants may sue over hiring practices, job discrimination or sexual harassment. Regulators may sue over conflict of interest, risky credit union policies or lack of policies, failure to comply with laws and regulations, failure to hold board or committee meetings, as well as a number of other reasons. Vendors sue over contract violations, failure to follow proper bidding practices, etc.

A credit union can get insurance called Directors, Volunteers, and Employees Insurance (DVE) that will help protect directors in case they or the board are sued over performance of official duties. The policy will pay for legal defenses and any judgments that result, with certain limitations. However, DVE won't cover everything. The credit union may need to supplement it with other insurance. In addition, insurance won't protect against liability for dishonest acts.

Board Time Management

A lot of research has been done in recent years about what makes for board and director effectiveness. Much of this research has been sponsored by the Filene

Research Institute. What the research suggests is that although financial oversight is essential, it's not the most significant duty of a good board. It doesn't ensure that the credit union thrives and serves its members well. And isn't that really the reason the credit union and board exist – to serve members well? The best-performing credit unions have boards that spend most of their time and attention on:

- Planning and evaluating
- Managing the CEO.
- Evaluating and making policies.
- Ensuring good member service.
- Representing the credit union in the community and with groups served by the credit union.

Planning and evaluating: This involves looking forward, toward the future, and deciding where the board and management want the credit union to be a year from now, and five years or ten years from now. It means creating a vision for the credit union – what the credit union should be for its members. Written down, this kind of vision is often called a vision statement.

The board works with management to establish goals that fit the vision. The board approves these goals, and then judges the performance of the manager on how well the goals are achieved. It's important that management take part in setting these goals, that management agrees they can be met, and that management has some flexibility in how to achieve these goals. If management isn't involved in goal setting, planning sets up conflicts between the board and management.

It's also important that goals be measurable. Otherwise, neither board nor management can judge how well goals

are being achieved. For example, the board and the manager might agree that the credit union should increase its membership. Without stating how much the membership should increase or setting dates, there is no way to measure whether the goal is being met. A sample goal might state: "The credit union will increase its membership by 5 percent in 20XX and another 5 percent in 20XX.")

Once goals are set, the effective board regularly compares the performance of the credit union with the goals that have been set. Is membership growing, for example, and by how much? Of course, the board should provide the management with the budget it needs to meet the goals. Setting a goal without providing the resources to do the job guarantees that the goal won't be met. The budget process provides a way to make sure aspirations are in line with fiscal realities.

Easily measured indicators of credit union operation could include financial figures and ratios, trends, number of members, call volumes, returns on marketing efforts, web site hits, etc. But goals should cover more than what's most easily measurable –- otherwise things like member service can be neglected in favor of meeting the numbers.

Boards need to set goals for things like member service, member satisfaction, and employee morale. These aren't easy to measure exactly, but there are some approximate ways to measure them. For example, surveys can measure the level of member satisfaction. Board members can directly observe how employees treat members. Management can keep track of member complaints. Employee turnover rates are one measure of employee morale. Employee surveys are also useful in determining employee satisfaction. The board can also keep track of employee participation in things like charity runs.

Managing the manager: Another very important task for the board, related to planning, is evaluating the performance of the manager and setting his or her compensation. In addition to the annual review, the manager's performance should be reviewed informally throughout the year. If the board sees performance slipping, or has some other problem with the manager, this should be addressed immediately. In other words, the annual review shouldn't contain any surprises for the manager.

The fact is, boards and managers have a good relationship most of the time. They get along well, they work cooperatively, and both are pleased with the relationship. But this kind of relationship takes work to develop and to manage. To develop and maintain this kind of good relationship, management and board should spend time discussing their responsibilities, and reaching agreement on what each of them will do. They should also take time to get to know each other. And they should communicate freely, not conceal information from each other. Lack of communication breeds mistrust. And trust is perhaps the most important single factor in board-management relations.

Evaluating and formulating policies: Another function of the board is to establish written policies that guide management in its day to day work. It's the job of management to translate these policies into written operating procedures that staffers follow as they do their work.

To show the difference between a board policy and an operating procedure, let's take dual control, which is the principle that at least two people should be involved in operations where there is a possibility of embezzlement – such as in lending or handling cash. The board might specify in general terms that dual control would be used in those situations, and management would spell out the

nuts and bolts of how dual control would be employed in situations like transporting cash.

Ensuring good member service: The board represents the members, and this is its most important function. Serving members well should be the central criterion for all credit union activities and planning. Every policy and operational procedure the board considers should be evaluated for its impact on member service. For example, if management wants to install an audio-response system, the board should look first at its impact on members. Of course, there are many different impacts of any audio response system. If it saves money, it helps to ensure good rates for members. If it speeds up service, that's good. But if it serves as a barrier to members and makes the credit union seem like an impersonal and distant institution, that can be off-putting to members and damaging to the long-range welfare of the credit union. Different credit unions will make different choices.

One hazard in setting goals is focusing on CAMEL ratings. CAMEL ratings are measures of safety and soundness, not how well the credit union is serving members. The board that insists that the credit union must get a CAMEL rating of 1 may be endangering the level of member service.

Representing the credit union in the community and with groups served by the credit union: Directors should think of themselves as ambassadors for the credit union. This is especially true of the board chair, who officially speaks for the credit union. All directors, but especially the chair, should promote the credit union where appropriate and educate people about credit union principles. For example, if a director belongs to a service club, he or she might volunteer to speak on what credit unions are and how they benefit members and the community. A board member should always comport himself or herself knowing that members, credit union sponsors,

and the community may judge the credit union based on his or her conduct. The adage, "Never do anything that you don't want reported in the news" is a good guide.

Working efficiently, in a cooperative and productive way.

Effective boards conduct efficient meetings by

- starting and stopping on time.
- using a written agenda that keeps discussions on track.
- spending most of their time on their significant duties such as planning and evaluating, rather than dwelling on accounting minutiae.

Boards take calculated risks when necessary. For example, not demanding the lowest possible loan delinquency ratio, if allowing a somewhat higher ratio will help to extend credit to members who really need it and perhaps bring better financial results than making only absolutely safe loans. Boards avoid the "we've always done it this way approach" to business.

The effective board commits to its duties. It masters its responsibilities, commits to constant education of directors, and seeks the best possible board candidates, not relying simply on the "old boy network."

The effective board works on unity, keeping debate vigorous but always cordial, being ready to compromise and seek consensus when possible, and planning special occasions such as breakfasts or outings where board members can get to know each other personally.

And the effective board communicates well – which helps build unity. The chair keeps directors and committees informed of all important information, and the board

establishes clear channels of communication with management.

During the past 40 years, boards of directors have been playing catch-up in terms of understanding their credit union's business. "With the increasing complexity of credit union operations and expansion of technologically driven products and services, the qualities and responsibilities of board members have increased in scale and scope," according to Raymond H. Lopez.[13]

In 2010, the National Credit Union Administration required federal credit union board members to be financially literate within six months of their election or appointment, such as being able to understand a balance or income sheet and important ratios and ask intelligent questions.

The competitive pace is particularly challenging for directors of smaller credit unions, who may be resistant to change. "Many institutions are managed and led by groups of sincerely good people who love their credit union but have no idea that they are killing it, by trying to keep the status quo," a consultant familiar with small credit unions confided to the author. "So they do nothing, hoping against hope they can amble along until their manager is ready to retire and they can quietly fold themselves into a larger credit union."[14]

One challenge for any credit union is recruiting qualified volunteer candidates. Credit unions responding to this challenge often:

- Have written job descriptions for volunteers, spelling out duties and responsibilities and the amount of time the post requires;

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13 *Credit Union Boards of Directors for the new Millennium,* 2001, Faculty Working Papers, Lubin School of Business, Pace University.

14 E-mail to author, 2014.

- Actively seek out top-notch candidates through a nominating committee; they may train potential board members by appointing them to committees;
- Try to have more than one candidate for each open position;
- Seek knowledgeable outside persons who by joining the credit union can be enlisted to run for board positions; however, these men and women should be thoroughly educated in credit union philosophy;
- Seek candidates reflective of the membership in terms of race, gender, ethnicity, and age. Research shows that the more diversity a board has, the better decisions it makes; and
- Balance experience with new faces by having term limits for directors.

Fortunately, movement organizations offer numerous training opportunities for directors, and credit unions that want to survive offer their directors continual education.

Chapter 8

Credit Union Management and Staff

In 2013, credit unions employed some 237,650 full time workers and 31,900 part timers. The great bulk of the employment was in credit unions above $50 million in assets. If research into employees of other nonprofit organizations holds true for credit union workers, they tend to be altruistic, mission-oriented, and socially conscious. In one study, more than 60 percent of non-profit employees said that they joined their organization "for the chance to make a difference, rather than for salary and benefits."[15] That compares to only 27 percent for federal employees and 22 percent for private sector employees.

This does not mean that pay and job perquisites are unimportant, but it does indicate that working in an organization with a strong philosophy of service is important to such employees, one more reason for emphasizing the "why" of the credit union when seeking to hire.

15 *Public Personnel Management,* Volume 35, No. 1, Spring 2006.

Serving members well requires having skilled, intelligent employees who enjoy their work and enjoy contact with members and other employees. And it involves having management that values its employees and invests in them with training, decent pay, and good working conditions. Such an investment pays back many times over, according to experts who have studied the subject.

The likelihood that credit union employees get much of their reward from fulfilling a mission puts into doubt many programs that seek to reward outstanding performance – either through "employee of the month" programs, "pay for performance," or bonuses for outstanding work. The idea behind such programs is competition among employees, which can have a negative effect on employees who rely on inner motivation, not external rewards. The time and funds invested in such programs might be better spent on training and day to day informal recognition and reinforcement of employee efforts.

However, a counterview comes from a credit union branch manager who e-mailed the author:

"Here at my credit union we pay incentives for lending goals and I have seen my team come together to make sure that everyone on the team is successful. I have had employees to make their goal and then turn around and give their co-worker the loans that they needed for them to make their goal as well.

"However, I would agrees that daily reinforcement from the management team along with how it is presented to the group is going to determine how successful it could be. Friendly competition is always good but it has to be handled properly....

"Also the credit union sets our goals for the overall success of the credit union such as lending, services per household, ROA, expenses, things of that nature so at

the end of the year we are rewarded for how many of those goals we hit as an organization. This also helps for the overall success of the credit union."

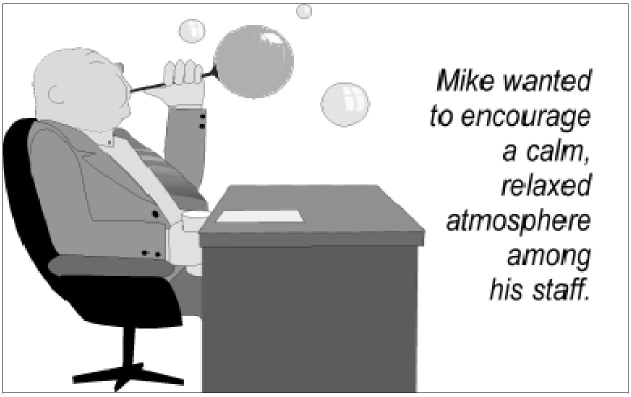
Role of Supervisors

A great deal of the responsibility for finding and training good employees rests with the human resources (HR) department. The HR department's functions can include:

- assisting departments in hiring and training;
- helping management set up job classifications and pay ranges;
- ensuring that the credit union complies with federal and state employment laws; and
- informing new hires about benefits and administering those benefits.

These are important functions that a credit union cannot afford to neglect. Because quality employees and the working climate of the credit union are so important in achieving management goals, the human resources department should have a seat at the table when it comes to strategic planning and goal setting.

But employees usually don't have a strong relationship with HR – their immediate supervisor is the person with whom they deal on a daily basis and who sets the work atmosphere. Generally speaking, it is supervisors and higher managers who are key to a productive workforce. They set the expectations and the tone of the workplace. The best employees in the world cannot do their job in an atmosphere of fear and recrimination or one of stagnation and lack of direction.



What does a typical credit union management look like? A great deal depends on the size of the credit union. The top manager, usually called the president and CEO (short for chief executive officer), reports only to the board of directors.

He or she manages the operations of the credit union according to the overall direction established by the board in cooperation with the CEO. The CEO, in addition to being a manager, should be a leader – looking ahead and working with the board to take the credit union into the future.

Peter Koestenbaum, author of *Leadership: the Inner Side of Greatness,* suggests that nonprofit leaders must have six critical characteristics:

Vision

A healthy sense of reality

An ethical, service-oriented character

Courage

Commitment

Ability to work with and through others

A leader must be able to win the trust of those he or she deals with. That is only possible by being both competent and open and honest.

The CEO's role goes beyond his or her job description. He or she sets the tone of the organization, "how things are done," also called the culture. Culture consists of the often unspoken customs and expectations that affect daily operations. It can hinder the success of an organization or be a powerful aid in accomplishing its mission.

Importance of Culture

In a 2013 international survey of 2,200 business executives, managers, and employees by Booz & Company, 84 percent agreed that culture is critical to an organization's success. Sixty percent agreed that it is more important than strategy or operating model.

There is often conflict between the stated values of an organization and the actual culture. For example, employees may be told that "my door is always open," but the executive is never available. The company may say it values employee initiative, but employee suggestions are ignored and independent action discouraged. Such conflicts promote cynicism and apathy.

E. M. Schein, a noted expert in organizational culture, lists five ways by which a leader shapes his or her organization's culture:

1. What the leader pays attention to, measures, and controls on a regular basis.
2. How the leader handles crises and other critical events.
3. How the leader allocates resources, rewards, and status.
4. Deliberate role-modeling, teaching, and coaching.
5. How the leader recruits, selects, promotes, and "excommunicates."

Below the CEO is a handful of executives collectively called senior management or the management team. What titles they bear depends on the individual credit union. Here is one large credit union's management team:

President and Chief Executive Officer

Executive Vice President and Chief Financial Officer

Senior Vice President and Chief Operations Officer

Senior Vice President and Chief Marketing Officer

Senior Vice President and Chief Lending Officer

Senior Vice President and Chief Information Officer

Middle Management

Below senior management comes "middle management." These folks are in charge of individual functions or departments. Their titles range from vice president to manager to supervisor. They transmit policies and instructions from senior management to employees. In addition to word of mouth communications, there are usually written policies and procedures employees are expected to follow.

In very small credit unions, this hierarchy may be flattened so a handful of people serve as management, and the CEO knows by name every employee.

Middle managers don't have an easy time of it. They are responsible to senior management but also represent employees to senior management. They can find themselves "between a rock and hard place" when asked to put unpopular policies small or large into effect (such as starting to charge for coffee that used to be free or eliminating branches).

Communication

The work of the senior management team is often clouded in obscurity from the point of view of employees. If

employees work in the same building, they may pass senior managers in the hall or even sit with or near them in the break room or cafeteria. They may even get to know them personally. But they are not privy to their meetings and don't always get the reasons for policies handed down.

There is a great deal of room for misunderstanding and resentment. That's why it is important for senior management (in fact, all levels of management) to make clear the reasoning behind decisions and to lay a groundwork of understanding before major changes in policy. This is particularly true in rough times when budget cutbacks and layoffs may be necessary. This can be done in a number of ways:

- Staff newsletters providing news of company developments and plans, printed and/or e-mailed.
- Bulletin board announcements, which should be changed frequently to ensure employee interest in reading postings.
- Memos.
- Meetings with employees and lower-level managers, including periodic briefings on the credit union's finances and goals.
- Videos and social media.

Upward communication is also important. In larger organizations, senior management can easily get out of touch with employees. This is an important responsibility of middle management, to keep tabs on employee morale and discontents, deal with them if possible, and let upper management know of problems developing. This is not always easy nor welcomed by top executives. But it's

needed. Some of the ways employees can be encouraged to communicate are:

- Suggestion boxes that are genuinely used by management, with recognition of good suggestions or suggestions that lead to correction of problems.
- A column in the staff newsletter in which management responds to employee suggestions and questions.
- A feature in the staff newsletter in which the editors solicit opinions from employees on various issues and print responses along with responses from management.
- Question and answer sessions with assembled employees.
- A culture that accepts and encourages employee curiosity about the course of the credit union and the work of management.

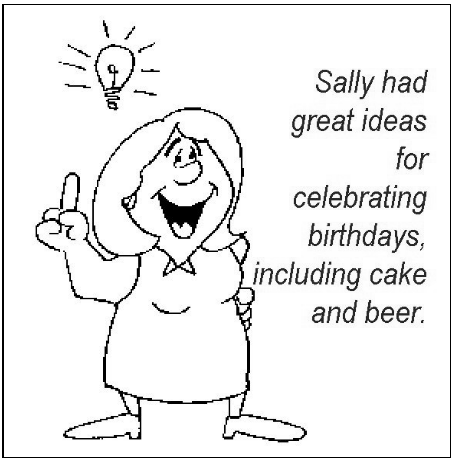
Some credit union CEOs and other senior officers make a practice of regularly visiting departments and branches that deal with the public, helping with duties for a day, and asking what might be improved to facilitate service to members. This not only promotes upward communication, it is a clear signal that upper management cares about employees and their opinions.

The alternative to clear communication between management and employees is not silence but the grapevine, also known as the informal organization. Employees talk among themselves, and news and rumors race through the organization at high speed. Management finds itself behind the curve on this, trying to squelch inaccuracies and often failing. Social media are extending the grapevine so even outsiders (including reporters) may get the latest rumor.

Senior management must be willing to share in the pain of tough decisions. When the author was on the staff of the Credit Union National Association, the association had to make cutbacks in a number of areas. Senior management took salary cuts as part of the process, which helped employees accept the sacrifices they had to make.

An important aspect of the workplace is relations among employees. Newspaper advice columnists are bombarded with questions dealing with office customs and relationships: Should the new employee join the others for drinks after work? How do you deal with a fellow employee who wears too much perfume? How do you respond to pressure to put in unpaid overtime or skip vacations? Should the employee speak honestly when asked for an opinion? How should birthdays, weddings, births, promotions be marked? What about dealing with malicious gossip? What about the manager who puts a hand on your arm when speaking to you? Should you fetch your boss's coffee?

In fact, much of the stress of working is dealing with others, not performing job duties. How the employee deals with peers, subordinates, and immediate superiors will have much to do with his or her success. The new employee at the very least should be sensitive to the informal cues that signal the office and organizational culture.



"Organizations are political by nature," observes Wendell V. Fountain, a credit union consultant.[16] "People are always jockeying for position, often at the expense of others. If an individual wishes to 'get ahead' in an organization, the best advice is to get a mentor or sponsor who has position and power, get under their wing, learn the rules of the game, and play; otherwise leave or accept the realities of organizational life without whining or complaining."

Tact and kindness go a long way to smoothing the path at work, but the employee should also be prepared to deal with people who try to get their own way at other people's expense or react to problems by getting angry. Disagreements can best be handled by staying calm, speaking quietly, and asking questions that help clarify the situation.

Like individuals, organizations are self-protective. They almost instinctively strive to put on a good face and downplay or conceal problems. The employee who threatens this stance by word or action can expect disapproval at best or retribution at worst. Whistle-blowers are seldom welcomed or honored.

If an employee believes something is wrong, alerts superiors, and management does not act, the employee must weigh the consequences of fighting to correct the situation. If it's a serious problem, like a breach of ethics or sexual harassment, he or she must be prepared to

16 *The New Emerging Credit Union World, 2012.*

look for another job if it's not corrected. There are laws to protect employees, but going to the law has to be a last resort, since it almost inevitably severs the tie with the organization.

Successful employees maintain a genuinely cheerful attitude and appearance with members and other staff.

A small number of credit unions have employee labor unions representing them with management. The union bargains with management on such matters as wages and hours, working conditions, hiring and firing procedures, and the like. The results of the bargaining are embodied in a contract that spells out what management and employees can and can't do. An employee union provides workers with protection from unfair or arbitrary treatment by management, but may hinder management's flexibility to respond to changing conditions and member needs. Employees of credit unions and other financial institutions have been slow to respond to organizing efforts by the union movement.

What does an organization have the right to expect from employees? Like volunteers, employees should demonstrate loyalty to the organization and its mission, carry out duties with care, and avoid conflicts of interest. Honesty is important, it almost goes without saying, as is keeping member information confidential.

Beyond those points, successful employees:

- Learn all they can about the credit union, the products and services it offers, and the history and philosophy of cooperatives and credit unions (One good way to learn is to attend meetings of the local credit union chapter, if one exists, where the employee can rub elbows with credit union executives and board officials. The chapter is a division of your state's credit union league.

- Take advantage of all training opportunities.

- Maintain a genuinely cheerful attitude and appearance,

- Are generous with "Good morning!" and "Thank you."

- Try to provide members and other staff not just good service but exceptional service beyond what they expect, and

- Cooperate well with others. Teamwork is an important part of modern credit union practice.

Employees cannot be expected to sacrifice family or health for the sake of the credit union. When personal problems arise, the credit union should be willing and able to offer whatever assistance is needed, from time off to take care of a sick child to referrals to the Employee Assistance Program (EAP).

Chapter 9

New Markets

Credit unions are exploring two markets that until now have not been much tapped: (1) small-business lending to members and (2) reaching out to the unbanked and underbanked. The first appears to have the most potential, as evidenced by the growing number of credit unions offering such loans. Though the credit union share of the total depository small-business loan market is less than 2 percent, these loans now comprise some 7 percent of the U.S. credit union loan portfolio.

Since the U.S. credit union movement began in 1908, some credit unions have made at least a few business loans, many of them agricultural. Business lending opportunities increased in the 1980s as relaxed field of membership requirements allowed credit unions to encompass increasing numbers of members, many of them small business owners. The number of credit unions reporting business loans grew from 789 (5 percent of 15,719 credit unions) in 1986 to 2,032 (30 percent of 6,795 credit unions) in 2013.

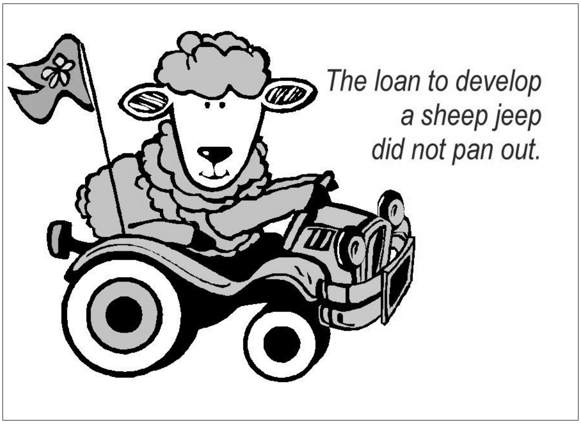
Janet Lee of the Callahan and Associates consulting firm notes that: "When the (Great Recession) hit, many banks pulled back on business lending and reduced or called lines of credit. Credit unions, on the other hand, ramped up their activity in the small business lending space and responded to members' needs....By supporting entrepreneurs and small business owners, credit unions have

helped maintain and strengthen their local, as well as the national, economy."

Member business lending is a growing field for credit unions. Author Photo.

In 2003, the Small Business Administration recognized the growing business lending of credit unions by expanding eligibility for its small business loan guarantee program from community chartered credit unions to all credit unions. Most business lending is done by larger credit unions. Some 47 percent of credit unions in the $50-$100 million range offer such loans, a figure rising to 92.8 percent among credit unions $1 billion and above.

In response to perceived competition in this area, the banking lobby succeeded in placing a limit on credit union business loans as part of the 1998 Credit Union Membership Access Act (CUMAA). Credit unions generally are limited to business loans comprising no more than 12.25 percent of their assets or 1.75 percent of their reserves, whichever is less.



Contrary to banker contentions, however, a 2011 study for the Small Business Administration by economist James Wilcox found credit union lending in this area largely supplements rather than takes away from bank business lending. It also helps to even out the flow of small-business lending by filling in when banks retreat from this area.

Few credit unions so far have approached or hit the CUMAA cap on business loans, but it is resented by the movement, which has been lobbying to have the cap raised. The law applies to most federally insured credit unions, but state charters in states that have what the National Credit Union Administration considers adequate member business lending rules are exempt. As of 2014, at least six states had developed such rules.

A few credit unions that traditionally made business loans above the cap were grandfathered in under the law. In addition, the National Federation of Community Development Credit Unions (NFCDCU) was able to get low-income credit unions exempted from the cap. This proved to be a key exemption when in 2012, NCUA streamlined the application process for winning a low-income designation. Hundreds of credit unions responded, swelling the pool of those not restricted by the business lending cap.

While most low-income credit unions are small, some are quite large. Suncoast Credit Union, Tampa, one of those

newly admitted to the group, is Florida's largest credit union, with $5.5 billion in assets. It had some $13.5 million in small-business loans as of January 31, 2014, well under the asset and capital caps. It planned to expand its business lending 30 percent over the next 18 months, but this would still be under the caps by a large margin. Its new designation did not so much allow it to expand its business lending as to apply for grants to help finance affordable housing and work with migrant laborers.

What's a Business Loan?

A credit union can make some business-type loans to its members that the National Credit Union Administration (NCUA) does not count as business loans and thus are not affected by the cap. If an individual member borrows less than $50,000, even though it is for a business purpose, that does not count as a business loan in NCUA's eyes. In addition, NCUA does not count loans:

- Fully secured by a primary family residence accommodating 1 to 4 households;
- Fully secured by savings;
- Fully insured, or fully guaranteed, or where the government has committed to purchase the loan;
- Made by a corporate credit union to another credit union. (A corporate credit union is one that serves credit unions rather than individuals.)

Loans classed as business loans:

- Are made only to members;
- generally require the personal guarantee of the borrower; and
- usually must be fully collateralized, that is secured by property or something of value.

According to a 2001 Treasury study, member business loans went largely to small businesses – landlords, taxi drivers purchasing medallions, and farmers. Many of those receiving loans were of modest income – 45 percent of the loans going to borrowers with annual incomes under $50,000. The average loan in 2012 was for $223,000.

Why would a credit union be interested in getting into this field?

In addition to filling an important need, "Everybody we've talked to recently says that from a priority standpoint, they want to grow, and one of the ways to do so is to grow the member business lending portfolio," says Tim McPeak, a director in the Financial Markets Group at Sageworks, a financial information company that provides risk management solutions to financial institutions.[17] "It seems to be a party line in the industry right now – that this is a growth area they want to pursue."

According to McPeak and other industry experts, credit unions are exploring business lending to:

- Increase penetration of the business market and the geographic market.
- Expand relationships established during the past recession.
- Diversify the balance sheet.
- Diversify revenue streams.
- Capitalize on competitive advantages.

Lending to business presents risks above and beyond those in ordinary consumer lending. NCUA requires that a credit union offering business loans have a loan officer

17 Quoted in the 2013 Sageworks white paper *Member Business Lending Landscape.*

with at least two years' experience in this field, but others recommend at least five years' experience. So far, credit unions seem to be handling the risk well.

Serving the Unbanked and Underbanked

Since the 1970s, the United States has developed a two-tier banking system. Banks and mainstream credit unions largely serve the middle-class and rich. A mushrooming number of "alternative financial services" or "fringe banks" serve the poor and lower middle class. More than one in four households conduct their financial business partly or completely outside the mainstream banking system, according to a 2011 survey by the Federal Deposit Insurance Corporation (FDIC).

Is this a potential market for credit unions? Some argue yes, if handled properly. The two markets of interest to credit unions are check cashing and so-called payday loans – short term advances on anticipated paychecks.

Check-cashing – Check-cashing outlets cash checks for a fee, most commonly between one and a half and three and a half percent of the face value if it's a payroll or government check, more if it's a personal check. In addition, these outlets usually provide a variety of other services. Patrons can pay utility bills, wire money, purchase money orders, make photocopies, and purchase prepaid telephone calling cards.

"The typical check-cashing outlet charges between 1.5% and 3.3% of a check's face value. For a typical client—who earns approximately $18,000 per year—this amounts to nearly $500 annually," states Mehrsa Baradaran, assistant professor at the University of Georgia Law School. Baradan is one of a number of critics who see fringe banking as taking advantage of the most vulnerable members of our society.

Payday Loans – In the early 1990s, the alternative financial services industry persuaded legislatures in a majority

of states to permit exceptions to their usury laws to allow higher-cost short-term loans secured by anticipated pay. Many check-cashing outlets added payday loans to their services, and the payday loan industry mushroomed from some 50 outlets to some 24,000 outlets. As of 2014, some 38 states had laws permitting payday lending. There are also a growing number of online payday lenders.

Connecticut, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, Vermont, Arizona, West Virginia, North Carolina, Guam, Puerto Rico, and the Virgin Islands have allowed their payday lending laws to expire. Arkansas repealed its payday law in 2011. Some other states place restrictions on payday loans but do not ban them outright.

This service requires the borrower to be employed and have an account at some depository institution. An example of a payday loan would be: A person borrows $100 until the next payday, two weeks from now. The lender requires the borrower to hand over a postdated check for the loan amount plus the fee, typically $15 for this amount, made out to the lender. When the loan becomes due two weeks later, the borrower can

1. Pay back the amount borrowed plus the fee, or
2. Allow the check to be processed, or
3. Pay the fee only and roll over the principal.

Four out of five payday loans are rolled over or renewed within two weeks, and one in five initial loans results in loan sequences of seven or more loans, notes Richard Cordray, director of the federal Consumer Financial Protection Bureau (CFPB). With a typical fee of 15 percent for each loan, consumers who renew loans seven times or more will pile up more in fees alone than the original loan amount. Such renewals account for much of the profitability of the payday loan industry. And when

fees are viewed as interest and expressed in term of Annual Percentage Rates (APRs), the fees paid by consumers seem astronomical – with APRs varying between 300 and 1,000 percent.

Alternative financial providers offer convenience. Author Photo.

The industry responds that such short-term loans are like taxi rides – a relatively expensive convenience for getting across town that you would not use for a long-distance trip. But consumer groups don't buy that argument. "The poor are often in greater debt after their interactions with payday lenders than before," says fringe banking critic Baradan.

Critics like Baradaran view check cashers and payday lenders as predators taking advantage of the less fortunate in America. The industry itself argues that it is providing a needed service and that without it, the economically marginal would have an even more difficult time.

How much harm do alternative providers do to their customers? It's not clear-cut. Research on whether payday lending hurts or helps those on the economic margin, for example, has shown mixed results. But, argues Kelly D. Edmiston, "The preponderance of evidence suggests that some consumers will likely face adverse effects if payday lending is restricted. Therefore, policymakers must carefully weigh the costs of payday lending restrictions against its benefits.[18]

The following sections address four questions:

1. Who uses fringe banking services?
2. Why do they use these services?
3. Are check cashers and payday lenders ripping off the poor, or are they making reasonable profits given their costs?
4. Can credit unions provide better, lower-cost alternatives?

Who Uses Fringe Banking Services?

About 17 million adults don't have any kind of deposit account, according to the Federal Deposit Insurance Corporation's 2011 survey. These people deal entirely in cash or use alternative financial services. They often use alternative providers to purchase money orders, cash paychecks, and send remittances. Prepaid debit cards are increasingly popular in these households. The fact that these individuals don't have a deposit account doesn't necessarily mean they don't save. They may park money in the deposit account of a friend or relative, stash cash in a hiding place, or buy gold or other valuables that can be sold or pawned when money is needed.

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18 *Could Restrictions on Payday Lending Hurt Consumers?* Federal Reserve Bank of Kansas City Economic Review, First Quarter, 2011.

Some 51 million adults have some kind of bank or credit union account, but they also use alternative financial services, including payday lenders.

Customers of alternative financial providers are generally people on the economic margin. The highest users of alternative financial services, according to the FDIC survey, are found among non-Asian minorities, lower-income households, younger households, and unemployed households.

A survey by the Pew Charitable Trusts found that payday borrowers, for example, usually use the loans to pay day-to-day expenses like rent, utilities, and credit card bills. Only 16 percent of borrowers used the loans for unexpected expenses like car repairs or medical emergencies.

"Typical payday loan applicants have poor credit scores in the low 500s, indicating an assessment by credit reporting agencies that they are already overburdened with debt and/or struggling to meet financial obligations," testified Nick Bourke, director of the Pew Safe Small-Dollar Loans Research Project before the Financial Institutions and Consumer Protection Subcommittee of the Senate Banking, Housing, and Urban Affairs Committee on March 24, 2014.

"More than half of payday loan applicants have credit card debt, two in five payday borrowers own homes (many with mortgages), and many also hold other debt." Bourke told the subcommittee.

Why Do People Use Alternative Financial Providers?

Those who live on the economic margin often lead harried lives, tugged in different directions. Customers of alternative financial services value their convenience, and they see alternative credit sources to be easier to obtain than bank or credit union credit, the FDIC survey suggests.

An industry trade association, Financial Service Centers of America (FISCA), offers these reasons why customers use these services:

- Traditional financial institutions are often difficult to find in working class and minority neighborhoods, having concentrated their locations in middle and upper class suburbs. (Note: This seems to be true in some cities, but not all.)

- Alternative financial service outlets offer better hours to accommodate varying work schedules. Many are open seven days a week, even 24 hours a day.

- Low-income individuals sometimes need a higher level of interpersonal service not often found in traditional financial institutions.

- There is significant cultural aversion to using mainstream financial institutions. Many immigrants come from cash-based cultures and are reluctant to trust financial institutions with their money.

- Alternative financial service staffs speak the language(s) of the neighborhood.

- Customers often lack the liquidity required to open and maintain bank accounts.

- Customers live paycheck to paycheck and have little, if any, money left over to put into a bank account.

To these might be added the fact that these individuals face barriers in obtaining or using bank or credit union services. These include credit checks, checkholds, bounced check fees, and overdraft fees. One study found that

payday loan applicants have frequently sought credit from mainstream sources before turning to the payday lender.[19]

Sometimes, users of alternative financial services are viewed as poor, naive, and uneducated. That is not necessarily true. According to their trade association, FISCA, two-thirds of their customers have annual household incomes of more than $25,000. Nearly 94 percent have high school degrees or better, and 56 percent have gone on to college.

Researchers have found that users of fringe services have rational reasons for using them. For example, the author had the privilege of being with a group of credit unionists studying the issue that visited a pawn shop in Raleigh, North Carolina. They spoke with the manager, who told about one customer, a small contractor, who parks his backhoe in the pawnshop side lot and borrows money on it to buy supplies. When he needs his machinery, he redeems it. In the meantime, he gets free parking for his backhoe.

The manager, incidentally, had a degree in philosophy, was working on an on-line master's, and was fluent in the Spanish spoken by many of his customers. He agreed that many customers would benefit from membership in a credit union, but he felt he was providing a real service. The credit unionists were so impressed by him that they urged him to get into credit union work.

Lisa Servon, a professor at the New School in New York City, worked for four months at a check-cashing outlet as part of her research into fringe banking. She discovered that:

"The glue at RiteCheck is the customer/teller relationship. I interviewed 50 RiteCheck customers after my

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19 Neil Bhutta, *Payday Loans and Consumer Financial Health,* Federal Reserve Staff Working Paper, 2013-81.

stint as a teller and, when I asked them why they brought their business to RiteCheck instead of the major well-known bank three blocks away, they often told me stories about the things the RiteCheck tellers did for them. Nina, who has lived most of her life in Mott Haven, told us that her mother had been very ill and that the RiteCheck staff had called to ask about her. 'So we can be family,' Nina said. 'We know all of them.'"[20]

Researchers Robert Stegman and Michael Faris note that focus groups of low-income and ethnic consumers cite five ways in which check cashers are superior to banks: (a) easier access to immediate cash; (b) more accessible locations; (c) better service in the form of shorter lines, more tellers, more targeted product mix in a single location, convenient operating hours, and Spanish-speaking tellers; (d) more respectful, courteous treatment of customers; and (e) greater trustworthiness.

Are These Businesses Ripping Off their Customers?

"The credit and payment services of AFS (alternative financial service) businesses are significantly more expensive than those of banks and credit unions," noted economist and pioneer fringe banking researcher John Caskey, in a study for the Filene Institute.

"There are two possible explanations for this observation. Either AFS businesses have significant monopoly power and earn extraordinary profits, or it must cost them more to deliver their services than it costs deposit institutions. I argue that a careful analysis largely supports the second explanation."[21]

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20 *The Real Reason the Poor Go Without Bank Accounts,* blog at theatlanticcities.com, 9-11-2013.
21 John Caskey, *Check-Cashing and Savings Programs for Low-Income Households: An Action Plan for Credit Unions,* Filene Institute, 2001.

The fact that banks and credit unions have generally avoided this market would seem to indicate that serving this niche is not particularly easy or highly profitable.

However, Michael A. Stegman and Robert Faris, who studied the payday loan business in North Carolina before it was banned, noted that "various sources indicate that payday lending generates large revenues and is highly profitable."[22]

The largest single share of expenses for an alternative financial service is the cost of the staff and the lease of space and equipment. A typical check-cashing outlet has two to three full-time employees, Caskey found, and operates at least 40 hours a week.

Profitability depends greatly on volume, increasing as the number of checks cashed or payday loans made increases. Because convenience of location is a major factor in attracting customers, each outlet serves a relatively restricted area. While operators tend to locate in heavily populated areas in larger cities, each store still has relatively few transactions. Caskey found that a "well-managed (check-cashing outlet) has annual revenues of between $150,000 and $180,000, about 70% of which comes from check-cashing fees. In order to attain these revenues, a store needs to cash about 1,300 to 1,500 checks a month."

New outlets often take several years to become profitable. To bring in more customers, outlets as noted earlier add additional services. Michael Lynch, a banker who deals with alternative financial institutions, says a check-cashing outlet “is a combination of many familiar businesses: bank, Mail Boxes Etc., corner store and video arcade. [The store] sells smokes at $4 a pack, buys gold and

22 *Payday Lending: A Business Model that Encourages Chronic Borrowing*, Economic Development Quarterly, Vol. 17 No. 1 February 2003.

diamonds, and dispenses candy and sodas from machines....[It will] wire in customers' utility payments for free and sell them envelopes, stamps, and money orders to pay other bills. [It] rents mailboxes and sells phone cards...and Lotto tickets."

Aaron Gold, an undergraduate in the Leonard N. Stern School of Business in New York University, conducted an analysis of payday lending in 2009. He found that the return on assets (ROA) was much higher than that of traditional consumer lenders, hovering around 10 percent from 2004 through 2008. As we have noted, banks and credit unions consider a 1 percent ROA satisfactory.

Much of this disparity results from the short-term nature of payday loans. "Because the maturities on payday loans are dramatically shorter than traditional loans, the amount of *average* assets—the denominator of the ROA equation—is much smaller for payday lenders than traditional lenders who keep loans on their books for an extended period of time," Gold explained. "Payday lenders are essentially able to generate income by lending, collecting, and re-lending a relatively small amount of capital."

The market opportunities, the lower capital requirements, lack of competition from mainline institutions, and the fact that fringe bankers either don't have to be licensed or find it easy to obtain a license, help explain the multiplication of outlets over the past decade and a half. However, profits from these operations do not appear to be unusually large, when costs are taken into account.

"Payday lenders typically offer two justifications for their high fees," notes Kelly D. Edmiston.

"First, their operating costs are especially high. For example, because an important attribute of payday lending for customers is convenience, payday lenders

must maintain a high density of stores and remain open beyond normal business hours," Edmiston states.

"Second, the incidence of default on payday loans is high. A 2005 FDIC study reported that the mean ratio of loan losses to total revenue for the two large payday lenders studied was 15.1 percent. Overall, this study and (other) research suggest that large fees on payday loans may be warranted.

"Further, evidence has shown that firm-level returns of payday lenders differ little from typical financial firms. Thus, while some payday lenders may take advantage of borrowers in some ways, payday lenders in general are not gouging borrowers."[23]

If alternative providers were making large profits, more traditional lenders would likely be invading the field, but they are not. "Check cashers and payday lenders—which currently provide the majority of nonbank financial services—are routinely criticized for charging unfairly high fees and interest rates. But even nonprofit operations and for-profit businesses with a social justice bent have had a hard time offering these services at attractively lower prices," notes researcher Lisa Servon[24]

"Prospera Community Trust, a nonprofit credit union with six branches in southern California, positions itself as a hybrid check casher and credit union. Jeannine Esposito, Prospera's manager of community engagement, also told me it has been tough to provide the services customers want while also keeping prices low.

"Spring Bank, a community bank with branches in the South Bronx and Harlem, undercuts its check-casher neighbors, charging 1% of the face value of a check to cash it, compared with the state-regulated ceiling of

23 *Could Restrictions on Payday Lending Hurt Consumers?* Federal Reserve Bank of Kansas City Economic Review, First Quarter, 2011.

24 *Op-Ed*, Wall Street Journal, 2-25-2014.

nearly 2% that most New York check cashers charge. This strategy attracts customers who might transition into more mainstream financial products, like checking accounts, which Spring Bank offers at a low cost.

"Yet director Demetris Giannoulias says the bank doesn't make money from check-cashing services. 'When we looked at the value proposition, we assumed that we could cut the fat from what other check cashers were charging and make the product sustainable,' he told me. 'What we found is that there's not much fat to be cut, but we still feel it's important to provide this service at these prices.'"

Credit Unions And the Check-Cashing Market

In his study for the Filene Institute, John Caskey challenged credit unions to get into the check-cashing market and offer consumers a better alternative. "Credit unions . . . are uniquely placed to assist the underserved and can benefit from the effort themselves."

Credit unions do cash checks for members at no or low cost, and this includes lower-income members. However, to reach many people now served by check-cashing outlets, they need to be able to perform this service for non-members. Low-income credit unions have had this power for quite a few years and so are in a position to compete with check-cashing outfits near them.

In 2006 a change in legislation allowed the National Credit Union Administration (NCUA) to permit federal credit unions to cash checks for non-members in the credit union's field of membership. Some states have followed suit. Larger credit unions often have extensive fields of membership that may encompass entire communities or regions. The change in regulations greatly expanded the opportunities for mainline credit unions to serve the check-cashing market. Credit unions also have formed credit union service organizations (CUSOs) to

cash checks for nonmembers within the fields of membership of participating credit unions.

The National Credit Union Foundation, through its Real Solutions® program, offers a downloadable "toolkit" offering advice on setting up a check-cashing program and case study examples.

As a result of these developments, many credit unions now cash checks for non-members, for various fees, often $5 per check. This can give them an opportunity to bring new members into the credit union. It is difficult to say, however, whether these measures are crimping the business of check-cashing outlets, especially since credit unions usually cannot offer the same convenient locations, hours, and variety of other services.

The move to cash checks for non-members does somewhat increase risk, CUNA Mutual Insurance Group (CMIG) notes in its Non-Member Check-Cashing Services Information Sheet: "However, if properly controlled, a credit union can minimize these new exposures to allow check cashing for nonmembers to be both a profitable service to the credit union and beneficial to consumers."

Credit Union Payday Alternative Loans

"Credit unions used to make payday loans," Nancy Pierce notes. "In fact, that was a large part of their business in early years....But somewhere along the way credit unions decided small loans were unprofitable and walked away from them. So the payday lenders came along, recognized a niche market and need, and learned that small, short-term loans could be made profitably. Now many credit unions are recognizing they can be a better solution and are adding payday-like products to their loan portfolios."[25]

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25 "Payday Lending: The Credit Union Way," 2008, CUNA Lending Council and National Credit Union Foundation/Real Solutions®.

In 2009, according to NCUA call reports, some 352 federal credit unions were offering various kinds of payday alternative loans to members. Approximately 650 federal credit unions were offering "micro loans," that is, loans under $500. The products were a mixture of open-end (allowing for rollover of the loans, similar to payday loans) and closed-end (fixed repayment period) loans.

Seeking to encourage more federal credit unions to offer closed-end payday alternative loans, the NCUA Board in 2010 raised the permissible interest rate on such loans from 18 percent to 28 percent – 10 percentage points higher. A federal credit union can also charge up to $20 for applying for such a loan, but no more than it actually costs the credit union to process the application. The rule comes with some restrictions, including:

- The loan amount is not less than $200 and not more than $1,000.
- The loan matures in from one to six months.
- The federal credit union does not make more than one loan per borrower and no more than three payday alternative loans (PALs) to the same borrower in any rolling six month period.
- The credit union does not roll over any PAL loan.
- The borrower must have been a member for at least a month.

As of 2014, some 500 federal credit unions reported making PAL loans with an aggregate balance of some $23 million, with the average loan balance of $382.

The National Credit Union Foundation's RealSolutions® program offers models for credit union payday programs. They include StretchPay, Better Choice, Prospera GoodMoney, Freedom Loan A&B, XtraCash, and SECU-SALO.

Alliances

Bethex Credit Union, headed by Joy Cousminer, is a community development organization in the distressed South Bronx. In 2001, it raised eyebrows within the credit union movement when it undertook a partnership with RiteCheck, a check-cashing company. Four years of planning and discussion with regulators went into the first pilot project with a RiteCheck outlet in the Bronx. The stated purpose of the alliance was to make credit union services – especially savings – more available to low-income people within Bethex's field of membership. As the Treasury Department has stated: "(L)ow income individuals with bank accounts are 43 percent more likely to have positive net financial assets than those without."

The alliance allowed Bethex to use the outlet as a low-cost "branch" office, with credit union literature and membership applications on display and the ability of credit union members using the outlet to make deposits and withdrawals with Bethex at no cost. Bethex also picked up the tab for members cashing checks at the outlet. (Bethex received a discount from the regular fee.) By 2012, other RiteCheck stores offered Bethex members a check-cashing discount that lowered the price from $1.86 to $1.50. Members could also deposit checks directly into their credit union account free of charge at all RiteCheck sites.

The alliance has expanded to include six other credit unions and several hundred locations of RiteCheck and a half dozen other check-cashing firms in greater New York City. Since 2001, credit union members have deposited more than $100 million through the alliance.

Advantages for the credit unions include avoiding the high cost of branches that might not be self-sustaining in

the areas where the check-cashing outlets are located, and attracting new members.

Advantages for Rite-Check included a greater volume of customers for its other services. The alliance also enables the business to offer a deposit account that otherwise it could not legally offer. And the alliance helps create a better image for RiteCheck.

Advantages for consumers include easier access to credit union services, no-fee check cashing, and greater convenience for credit union members in the neighborhood.

Another East Coast alliance was formed in Baltimore in 2002. SSA Baltimore Federal Credit Union (now SecurityPlus Federal Credit Union) sought to bolster its dwindling membership as the federal government downsized. It won a charter change to serve nearly all of Baltimore. It opened part-time outlets in various locations, one of which was in a nonprofit-organized financial services and counseling center called The Money Place.

The branch office at the center offers non-cash credit union services. The cash needs of the community are met by an ATM and a check-cashing outlet at the center. The outlet is operated by A&B Check Cashing, the area's biggest check-cashing operation with 20 sites in the Baltimore Region. At The Money Place, A&B cashes checks at a reduced rate and provides money orders, bill payment, and photocopying services.

"We originally saw ourselves opposed to (check cashers) since we felt they took advantage financially of people in low-income and unbanked areas," the credit union's CEO told *Credit Union Management*. "We saw ourselves as the 'white knights,' rolling in to offer a better financial way to the citizens in these areas – and still do, to be truthful about it."

Brian Satisky, who owns A&B with his brother Brian, told the Baltimore Sun: "Traditional banking and non-

traditional financial services have always been sort of pitted against each other. "This center is going to show the public that the two industries can work together and really provide very important services for people."

In 2007, on the West Coast, Kinecta Federal Credit Union, Manhattan Beach, California, purchased a chain of 55 Nix check-cashing outlets in 2007 to serve as credit union branches. The outlets also offer payday loans. The $45 million deal tripled Kinecta's branch network. "We will now be able to offer the opportunity of becoming a Kinecta Federal Credit Union member/owner to all of the Nix customers in the . . . areas around the Nix branches, said then Kinecta president and CEO Simone Lagomarsino.

The Nix outlets are now a Credit Union Service Organization (CUSO) owned by Kinecta. The National Credit Union Administration (NCUA) approved a field of membership expansion to allow the credit union to serve the five million people in the areas around the Nix outlets. It was one of the largest such expansions ever granted by the NCUA.

The news of the proposed purchase of the Nix chain aroused enough interest in the financial world that Harvard's business school made it one of the school's famous "case studies," in which students were asked to analyze the potential sale and its effects on the two organizations.

But Kinecta's program has drawn criticism. In 2013, the Center for Responsible Lending and the National Consumer Law Center called on NCUA to investigate the payday lending aspect of the program, which they termed "predatory."

Chapter 10

Cooperation Strengthens Movement

American credit unions have benefited by working together to create organizations that support their efforts. By 1921, the credit union movement begun in New Hampshire had spread to several states. Massachusetts had around 80 credit unions. Realizing that they needed each other to make progress, many of the state's credit unions met and formed a trade association, the Massachusetts Credit Union League. The league was democratically governed by an annual assembly composed of two delegates from each member credit union.

Meanwhile, Boston merchant and philanthropist Edward A. Filene had hired a lawyer to spread the word about credit unions. Roy F. Bergengren proved to be just the person for the job. He traveled the country promoting credit unions, finding volunteers to organize them, and pushing for state laws to authorize them. Thanks to Bergengren's efforts, the credit union idea took root in state after state. Hundreds, then thousands, of credit unions sprang up. As the movement grew, more state leagues were formed.

These leagues had several purposes. One of them was to help organize new credit unions, for which they hired field representatives to visit factories, schools, and other sites ripe for organizing. The representatives also helped the volunteers who typically ran the credit unions to deal

with accounting and other business issues. The leagues advocated for improvements to their state credit union laws and provided a forum in which issues of interest to members could be discussed.

In 1934, Congress passed and President Franklin Roosevelt signed the Federal Credit Union Act, which permitted credit unions to be chartered even in states lacking credit union laws. That same year, league and credit union representatives met at Estes Park, Colorado, to form a national trade group, the Credit Union National Association (CUNA). For many years, CUNA was owned and governed by the state leagues, while credit unions were affiliated through their league. Today, credit unions belong both to their league and CUNA. CUNA has two locations. Its senior staff is headquartered in Washington, D.C., while operational departments like publications are located in Madison, Wisconsin.

As credit unions have grown in size and professionalism, their needs have changed, and so have league and CUNA operations. Most leagues no longer have field representatives but continue to carry on many other functions, ranging from lobbying in state capitals to publications, education, legal advice, and public relations. They help credit unions, especially smaller ones, comply with the ever-growing number of laws and regulations governing operations. Credit union consolidation has led to league consolidations, with a number of leagues operating on a regional rather than a state basis.

Among the leagues that have taken the consolidation path are North and South Carolina (Carolinas Credit Union League); Arkansas, Oklahoma and Texas (Cornerstone Credit Union League); Alabama and Florida (League of Southeastern Credit Unions); Arizona, Colorado and Wyoming (Mountain West Credit Union Association); Oregon and Washington (Northwest Credit

Union Association); and Massachusetts, New Hampshire, and Rhode Island (Cooperative Credit Union Association).

Chapters in each city are an important part of league life. Credit union executives and other staffers, together with board members, hold monthly chapter meetings to hear speakers, discuss issues, share ideas, brainstorm mutual projects, network, and simply have a good time. This has a strong unifying effect on the local movement even though individual credit unions often are competing with each other for members and business.

CUNA and its member leagues offer credit unions a variety of products and services apart from traditional association activities like advocacy. These can include seminars and conferences, on-line education, credit and debit card processing, data processing, and the like. Together with dues, earnings from these activities help financially support the leagues and CUNA.

Of importance, too, are the CUNA councils, organizations for specialists working in credit unions. As of this writing, there are six councils dealing with lending, human resources, information technology, marketing, operations, and finance. These councils conduct research and provide opportunities for members to meet, exchange ideas, and network.

Mention should be made of the National Credit Union Foundation (NCUF), and various league foundations, which channel the charitable efforts of the nation's credit unions. Credit unions contribute millions of dollars for such causes as children's hospitals and disaster relief. In addition to NCUF's charitable activities, its RealSolutions™ program researches and develops programs and tools to help credit unions offer consumers, especially low-income consumers, affordable financial services like financial education, building savings, building assets, and buying homes. The

Foundation also runs the Credit Union Development Education Program to train credit unionists in credit union philosophy and community development.

NAFCU

In 1961, some 50 federally chartered California credit unions unhappy with some of CUNA's legislative positions formed the National Association of Federal Credit Unions. Its principal purpose was to lobby for the federal legislation its members sought. Today, NAFCU's membership includes some of the nation's largest credit unions and has a strong voice in Washington, D.C., along with CUNA. Most of NAFCU's members also belong to CUNA. The two organizations try to coordinate their lobbying efforts and most of the time are on the same side on issues. NAFCU is headquartered in Washington, D.C.

Corporate Credit Unions

Many people do not know of the existence of credit unions that serve not individual members but credit unions. A corporate credit union provides a place for its member credit unions to invest surplus funds and borrow when needed. The corporate system was reorganized by the National Credit Union Administration after several corporates suffered heavy losses in the Great Recession of 2008-2009 and were liquidated. The remaining corporates still provide a useful service to their members.

CUNA Mutual

CUNA Mutual is the credit union movement's principle insurer. It was formed by CUNA in 1935, shortly after CUNA itself was formed. It insures credit unions against natural disasters, robberies, and many other contingencies, but has expanded its operations outside the movement to include individual insurance Like other credit union organizations, it is owned and governed by

its member credit unions. Besides its insurance functions, CUNA Mutual has helped to finance many movement activities ranging from legislative campaigns to the movement's "think tank," the Filene Research Institute. It has also been active in the international credit union movement. The insurer is headquartered in Madison, Wisconsin.

Filene Research Institute

The Filene Research Institute was founded in 1989 by CUNA Mutual, CUNA, the leagues, and contributing credit unions. It is the movement's "think tank," sponsoring research by experts on issues of concern to credit unions, ranging from fringe banking to field of membership to board efficiency. Over the years, it has contributed valuable insights into credit union issues. It is located in Madison, Wisconsin.

World Council of Credit Unions

For many years, CUNA worked to spread the credit union idea to other nations, ranging from Latin America and the Caribbean to Africa and Asia. In 1971, it turned over this responsibility to a new organization, the World Council of Credit Unions (WOCCU). WOCCU's membership consists of the credit union movements of various countries and regional confederations. CUNA is one of those members. WOCCU has a staff of specialists who can assist national movements, and it also acts as a conduit for foundation and U.S. government economic development aid. It tracks international credit union statistics, offers publications, sponsors International Credit Union Day® each October, and holds regional and international conferences. It includes movements in nearly 60 countries. It is headquartered in Madison, Wisconsin.

Credit Union Service Organizations

Several hundred credit union service organizations (CUSOs) have been formed by credit unions and leagues since the 1970s. These are for-profit organizations set up to perform tasks that individual credit unions cannot do for themselves or find it cheaper to outsource to the CUSO. As of yearend 2012, 476 credit unions owned CUSOs and another 2,139 either shared in the ownership of or had loans out to CUSOs.

"CUSOs are hotbeds of innovation," says Jack Antonini, president and CEO of the National Association of CUSOs (NACUSO). "Typically, innovation costs money. Doing research and development to come up with new products and services is an expensive proposition. Given the fact that most credit unions have less than $100 million in assets, they don't have the resources to invest in innovation. Through CUSOs, credit unions come together to do what they can't do alone."[26]

Services offered by CUSOs include checking and currency services, clerical, professional, or management services, business or mortgage lending, financial counseling, payroll processing, and many other activities.

One of the most important functions provided through CUSOs is shared branching. Shared branching networks like CO-OP Financial Services allow credit union members to use thousands of credit union branches or kiosks to do business with their own credit union. This type of service is particularly useful for credit union members who live near a CUSO branch, are traveling, or those who have been forced out of their communities by natural disasters like Hurricane Katrina or Hurricane Sandy. A credit union can choose to be an "issuer," that is, permit its members to use the network, or an "ac-

26 "CUSO Collaboration," *Credit Union Magazine," June 1, 2012.*

quirer" providing branch services to members of participating credit unions nationwide – or both.

Cooperation With Other Types of Cooperatives

For many years, credit unions had a somewhat distant relationship with the rest of the cooperative movement, although a number of farm and other coops sponsored credit unions. Part of this grew out of not wanting to be identified with the broader cooperative movement at a time when conservatives were labeling it "socialist" and "communist." In recent decades, credit unions have been moving closer to their fellow cooperators.

The main organization of the overall cooperative movement in the U.S. is the National Cooperative Business Association (NCBA). CUNA and a number of leagues and credit unions have joined the NCBA. The general cooperative movement has been a valuable ally in helping to defend credit union interests in Washington, D.C. The National Credit Union Foundation has been working to develop ways credit unions can help finance cooperative ventures like natural food coops.

About the Author and This Book

A graduate in English of the University of Wisconsin-Madison, Paul Thompson began his career as a newspaper reporter. After working on two newspapers, he became a writer for and then editor-in-chief of a weekly current events filmstrip viewed by hundreds of thousands of children.

After 17 years at that work, he and his wife Evelyn established a free-lance writing, editing, and public relations agency working mainly with trade associations and corporations. He also published several science books for young people and an easy-reading novel for teenagers.

A credit union member since his cub reporting days, Thompson joined the public relations department of the Credit Union National Association (CUNA) in 1986, where he was speechwriter for the elected leadership and the president's office. He retired in 1998 but continued writing speeches, articles, and training manuals for CUNA and the World Council of Credit Unions.

Thompson is a Credit Union Development Educator. Long interested in credit union history, he was hired by CUNA's Information Resource Center (IRC) to research and write a history of the movement from 1980 to 2000, including interviewing many credit union leaders. This history has been used as a resource by the IRC in responding to queries.

Thompson independently continued his research and interviewing, which resulted in a completely new and

detailed look at the development of the modern U.S. credit union movement. Entitled *Development of the Modern U.S. Credit Union Movement 1970-2010,* it was granted the 2013 Individual Achievement Award of the Credit Union Development Education program of the National Credit Union Foundation.

Thompson and his wife are members of a writer's collective that produces a monthly radio program of original poetry, essays, and music broadcast by some two dozen community radio stations around the nation.

He invites readers of this book to contact him with comments, criticisms, or corrections by mail to 2241 South Syene Road, Fitchburg, Wisconsin 53711.